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FSOC ACCOUNTABILITY: NONBANK DESIGNATIONS

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED FOURTEENTH CONGRESS

FIRST SESSION

ON

EXAMINING THE TRANSPARENCY AND ACCOUNTABILITY OF THE FSOC'S SYSTEMICALLY IMPORTANT FINANCIAL INSTITUTIONS DESIGNATION PROCESS FOR NONBANK FINANCIAL COMPANIES

MARCH 25, 2015

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FSOC ACCOUNTABILITY: NONBANK DESIGNATIONS

WEDNESDAY, MARCH 25, 2015

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 2:01 p.m., in room SD–538, Dirksen Senate Office Building, Hon. Richard Shelby, Chairman of the Committee, presiding.

OPENING STATEMENT OF CHAIRMAN RICHARD C. SHELBY

Chairman SHELBY. The Committee will come to order.

Today, the Committee will examine how the Financial Stability Oversight Council, or FSOC, designates certain nonbank companies as "systemically important." First we will hear testimony from Treasury Secretary Jack Lew, who chairs the FSOC. We will then turn to a panel of experts.

Dodd-Frank established FSOC to identify and mitigate risk to the financial stability of the United States that may arise from the material financial distress of bank holding companies or nonbank financial companies. There is no precedent in our regulatory regime for a Council like this. Further, when you give such a body extraordinary powers, those powers must be exercised with requisite care.

The Council has the authority to designate a nonbank institution as "systemically important" and subject it to enhanced prudential standards and regulation by the Federal Reserve. This new layer of regulation does not come without a cost to our economy. Enhanced prudential requirements impose significant costs on banks and nonbank entities.

Because much rests on an institution's designation, I believe that FSOC has a heightened duty to be as transparent and judicious as possible. However, FSOC's previous designations have been criticized for lacking transparency, failing to produce clear indicators to guide others, and merely following the international regulatory bodies. If such criticism has merit, Congress should be concerned because this is not how a regulatory regime ought to function.

Our regulators should be transparent, issue clear guidance, and be free from the undue influence of international bodies. The Financial Stability Board, or FSB, is one such international body that monitors and makes recommendations about the global financial system. The FSB, however, is not a U.S. regulator, and it is not accountable to Congress or to the American people.

Nonetheless, two out of the three insurance companies that FSOC has designated as "systemically important" were first des-

ignated by the FSB. I believe this creates a regulatory conflict because 3 of the 10 FSOC voting members—Treasury, the Fed, and the SEC—first engage at the FSB level to determine if a U.S. company is systemically important.

When they return to the U.S. and supposedly engage with the rest of the Council to consider whether a company is systemically important, they have for all intents and purposes already, I believe, made up their minds. I think we must ask if the influence that the FSB seems to exert over the FSOC's process is real and whether it is appropriate. FSOC designation process has little merit if it is merely used to justify an international organization's determination, rather than engage in an independent analysis.

Moreover, given that the designation is a determination of risk to the U.S. financial system, I think it should ensure that the steps to mitigate that risk are identified and articulated before a company is designated.

While it has announced a series of steps aimed at increasing transparency, most critics do not believe that such efforts sufficiently address the concerns that have been raised. We must, therefore, ask the following questions:

First, has FSOC clearly disclosed what factors make a company systemically important and the relative weight it has assigned to those factors?

Second, is it clear what needs to occur to reduce the systemic risk of such a company? In other words, does a company know how to avoid designation to know how to be undesignated?

Third, is the designation process sufficiently open, objective, data-driven, and free from the influence of outside organizations? Today's panels will hopefully shed some light on these questions as the Committee considers whether changes to this process need to be made.

At this point, without objection, I would like to enter into the record statements from the National Association of Insurance Commissioners; Mr. Peter Wallison; the Bipartisan Policy Center, including its report entitled "FSOC Reform: An Overview of Recent Proposals"; Mr. Benjamin Lawsky, Superintendent of New York State Department of Financial Services, regarding the MetLife designation; dissents of Mr. Roy Woodall, independent member having insurance expertise on that; Mr. John Huff and Mr. Adam Hamm, State Insurance Commissioners representatives regarding the MetLife and Prudential designations.

Today's hearing will be compromised of two panels. The first panel will be the Treasury Secretary, Jack Lew, who also chairs the FSOC.

Mr. Secretary, at this point we want to welcome you to the Committee. You are no stranger here. Your written testimony will be made part of the record, and we look forward to having a chance to talk with you.

Senator Brown has joined us. Any statement you want to make?

STATEMENT OF SENATOR SHERROD BROWN

Senator BROWN. I am sorry, Mr. Chairman. I did not hear your opening statement, but it is good to be here. Thank you so much.

Secretary Lew, welcome, and to the second panel, thank you also for joining us.

As one of our witnesses on Tuesday pointed out, regulators did not exactly cover themselves in glory leading up to the 2008 financial crisis. Congress certainly played a role as well. We had a patchwork financial framework that allowed financial institutions to evade oversight and often pitted regulators in a race to the bottom. Nonbanks like AIG and Bear Stearns built up risks by moving activities to unregulated space. American taxpayers paid the price in lost homes and jobs and billions of bailout dollars. My wife and live in a zip code in Cleveland, Ohio, that had the highest rate of foreclosures of any zip code in the country several years ago.

Secretary Lew's predecessor, Secretary Geithner, proposed the FSOC to fill gaps in the regulatory framework and create a forum for agencies to resolve issues. The idea had the support of appointees of President Bush and of President Obama.

FSOC is working. If anything, it is working too slowly. Since FSOC's creation 5 years ago, it has only designated four nonbanks as "systemically important." By my math, that is less than one a year. They have designated eight systemically important financial market utilities without any objections that I am aware of.

This is a critical responsibility given the increased importance of clearinghouses under the derivatives clearing mandates in Dodd-Frank. FSOC provided a forum to force reforms to the structure of some money market mutual funds. It has been responsive to consumer and industry groups in their concerns about transparency. We hear a lot about transparency and accountability because they are concepts that no one should oppose.

But I am concerned by proposals that would tie the FSOC's hands, making it too burdensome for FSOC to designate any institutions, and taking us back to a time when no entity was responsible for watching over the entire financial system. That is why we welcome Secretary Lew to discuss that. I would look forward to hearing about FSOC's work identifying and addressing risks, and I appreciate the Chair calling this hearing.

Thank you.

Chairman SHELBY. Mr. Secretary, welcome again to the Committee.

STATEMENT OF JACOB J. LEW, SECRETARY, DEPARTMENT OF THE TREASURY

Secretary LEW. Thank you very much, Chairman Shelby, Ranking Member Brown, Members of the Committee. I appreciate being here and look forward to my testimony today.

As everyone here today remembers well, the financial crisis caused enormous hardship for millions of individuals and families and communities throughout the country, and it revealed a number of central shortcomings in our financial regulatory framework. We saw the consequences of lax regulation and supervision at financial firms like Lehman Brothers and AIG, names that are now written into history as companies whose failure or near failure contributed to the near collapse of our financial system.

At the time, the regulatory structure was ill equipped to oversee these large, complex, and interconnected financial companies. This

outdated structure also meant that regulators had limited tools to protect the financial system from the failure of these companies.

As a result, the American taxpayer had to step in with unprecedented actions to stop the financial system from collapsing. Congress responded with a historic and comprehensive set of financial reforms: the Dodd-Frank Wall Street Reform and Consumer Protection Act, which put in place critical new consumer protections.

Equally important, this reform guarded against future crises while establishing as a matter of law that taxpayers never again be put at risk for the failure of a financial institution.

To lead the effort to better protect taxpayers, Wall Street reform created the Financial Stability Oversight Council, for the first time bringing together in one body the entire financial regulatory community to identify risks in the financial system and work collaboratively to respond to potential threats to financial stability. Over the past 5 years, FSOC has demonstrated sustained commitment to fulfilling this critical statutory mission in a transparent and accountable way.

The work has not been easy. We built a new organization and developed strong working relationships among FSOC members and their staffs to foster candid discussions, the exchange of confidential, market-sensitive information, and to encourage tough questions that must be addressed to make our financial system safer.

FSOC now convenes regularly to monitor market developments, to consider a wide range of potential risks to financial stability, and, when necessary, to take action to protect the American people against potential threats to the financial system.

Our approach from day one has been data-driven and deliberative, while providing the public with as much transparency as possible regarding our actions and views. We have published four annual reports that describe our past work and future priorities. Regularly we have opened FSOC meetings to the public. We have published minutes of all of our meetings that include a record of every vote the FSOC has ever taken, and solicited public input on both our processes and areas of potential risk.

I and the other members nonetheless recognize that FSOC is a young organization that should be open to changes in its procedures when good ideas are raised by stakeholders. Just over the last year alone, FSOC has enhanced its transparency policy, strengthened its internal governance, solicited public comment on potential risks from asset management products and activities, and adopted refinements to its nonbank financial company designation process.

I believe that our adoption of these changes to the nonbank financial company designation process represents the right way for FSOC to refine its processes without compromising its fundamental ability to conduct its work.

After extensive stakeholder engagement, FSOC adopted supplemental procedures last month under which companies will know early in the process where they stand, with earlier opportunities to provide input. The changes will also provide the public with additional information about the process while still allowing FSOC to meet its obligation to protect sensitive, nonpublic materials.

And, finally, FSOC will provide companies with a clearer and more robust annual review process. This will open the door to more engagement with FSOC following a designation to make sure there is ample opportunity to discuss and address any specific issues that a company wants to put before the Council. These changes strengthen the FSOC process while also addressing many of the suggestions made from stakeholders.

On a related note, I am pleased to report to this Committee that the vast majority of key reforms contained in Wall Street reform are now in place due to the hard work and diligence of the independent regulatory agencies. Today, because of the passage of Wall Street reform nearly 5 years ago, the financial system is more robust and resilient than it was before the crisis. We have reduced overall leverage in the banking system. Banks have added over $500 billion of capital since the crisis to serve as a buffer for absorbing unexpected losses. And the recently completed annual stress tests cover a wide swath of institutions, illustrating that our largest banks have sufficient capital to withstand adverse shock scenarios and continue to lend to businesses.

The true test of reform should not be whether it prevents firms from taking risk or making mistakes, but whether it shapes a financial system strong and resilient enough to support long-term economic growth while remaining innovation and dynamic. In working toward this end, Treasury and the independent regulators continue to carefully monitor the effects of new reforms. Both the law and the implementing regulations make clear that there is no one-size-fits-all approach and that requirements must be calibrated to the different size, complexity, and risk profile of institutions.

Just as the business environment is constantly evolving, the regulatory community must be flexible enough to keep up with the new challenges, including making adjustments where necessary and remaining vigilant to new emerging threats.

Promoting financial stability and protecting the American public from the next financial crisis should be an objective shared by the Administration, regulators, the financial sector, and Members of Congress regardless of party or point of view.

I look forward to working with you to make certain our financial system becomes even more resilient and stable, and I look forward to answering your questions.

Chairman SHELBY. Thank you, Mr. Secretary.

Mr. Secretary, in Stage 2 of the designation process, FSOC applies a six-category framework in its analysis of a nonbank financial company. Commentators have noted that the public has no clear understanding of the relative value or weight of these factors.

What is FSOC doing to provide both the public and the designated companies with a better understanding of the relative weight of each factor? And what makes a designation more likely?

Secretary LEW. Mr. Chairman, as you know, the process that FSOC uses is a very transparent one. It has been published. The criteria are out there. And each one is a separate review.

I think it is a mistake to think about a one-size-fits-all approach because no two large, complex financial institutions will be exactly the same. So the relative weight of factors will be different depend-

ing on what the composition of a firm and the nature of the risk is.

In each case, we apply the same review, which is a deliberative review. It involves details analysis, much back-and-forth between the firm and FSOC, and in the end hundreds of pages of analysis published and shared with the company. And we analyze basically three transmission channels for risk in each case, and we go through each of those, and if there is a determination that there is systemic risk, as the statute requires, we make a designation. But——

Chairman SHELBY. Do you go through those risks with who you are thinking about designating? Or do you just do this internally?

Secretary LEW. Well, there is a lot of back-and-forth between the firm and the FSOC, and based on the new procedures we have put in place, it will be somewhat more formal. But I want to be clear: Even before the rules change, there was a lot of back-and-forth between the firms and FSOC already. So it is not that there was not thousands of pages of data and analysis provided.

Chairman SHELBY. It is my understanding that multiple members of FSOC have submitted additional recommendations for improving transparency, which you mentioned, and accountability. What additional recommendations were submitted by members but not incorporated, in other words, you considered and did not incorporate? And what additional recommendations will FSOC adopt next and when?

Secretary LEW. Well, Senator——

Chairman SHELBY. Is that too soon to tell?

Secretary LEW. I was going to say, over the past year we have made two rounds of changes, which I think represent a consensus of the changes that we needed to make and actually reflect the views expressed by many Members of Congress and parties, stakeholders as well.

We are going to continue to look at ideas that come forward and have not in any way ruled out taking further action. But I think that we ought to let the changes that we have made settle in so that the parties can deal with the system as it now stands. But we welcome an ongoing discussion, and as I think the actions show, we have made changes when they seem appropriate.

Chairman SHELBY. Mr. Secretary, it would seem to me that in order to properly assess if FSOC's designations are, in fact, reducing threats to our financial system, the FSOC would need to know what regulations and standards the Federal Reserve will impose on the designated companies. In other words, how can FSOC designate a company if the Fed has yet to promulgate rules to regulate such a company? Do you follow me?

Secretary LEW. I do follow you, but, Mr. Chairman, as the statute requires, FSOC has to make a determination as to whether or not there is systemic risk. The task of supervisory responsibility goes to the Fed. The Fed is in the process of implementing those rules, and obviously Congress has now enacted some legislation that gives them greater flexibility to adopt rules that distinguish between, say, insurance companies and traditional financial institutions.

So I think that the process is moving sequentially, and as the firms have to comply, that process will unfold in an orderly way. But it is the Fed's responsibility going forward.

Chairman SHELBY. My follow-up question here would be: How can FSOC determine that it is reducing systemic risk when it has, one, neither identified the specific activities that create systemic risk or, two, has the knowledge of what regulatory steps would be taken to mitigate such risk?

Secretary LEW. Well, the task of going through the analysis to determine whether there is a systemic risk is the responsibility of FSOC. By designating the firm, the firm then is subject to supervision under the statute by the Fed. I think that process is one that makes our system safer. I have confidence that the Fed will take that responsibility very seriously.

Chairman SHELBY. But has the Fed done that yet?

Secretary LEW. They are in the process of working it through.

Chairman SHELBY. So they have not done it yet.

Secretary LEW. No firm has had to go through the process of actually submitting all of the documentation through the process. They have been designated, and now there is a time where the Fed will put in place the rules that they comply with, and they will then comply.

So I think some of this is a bit—it is a young organization. We have just designated the firms, and it is happening in proper order and due course.

Chairman SHELBY. Are you building the cart before you buy a horse here?

Secretary LEW. No, I do not think so, Senator. I think that the task that was given to FSOC, which no entity in the Federal Government had prior to the creation of FSOC, was to look across the spectrum: Where is the risk of the future possibly going to come from? The designation process was given to FSOC. The actual regulatory supervision is not—FSOC does not do that directly. So I think it is working in the right order, and I am not sure how to take the cart and the horse metaphor, but you need a cart and you need a horse, and——

Chairman SHELBY. Well, what do you need first?

Secretary LEW. You need both.

Chairman SHELBY. Yeah, but a cart without the horse is not going very far, is it?

Secretary LEW. I think I have a lot of confidence that the Fed has a lot of experience with supervisory matters, and they are going through this in an orderly way to make sure that it is done in an appropriate way.

Chairman SHELBY. Senator Brown.

Senator BROWN. Thanks, Mr. Chairman.

Mr. Secretary, you know this Committee has been discussing and improving regulation for credit unions and community banks. I have said that we on this side will support ideas that have broad bipartisan consensus. One issue as an example is the written privacy notice requirement if a policy has been changed.

Today the House Financial Services Committee is marking up a set of proposals. Tell us what you think about the proposals they

are marking up, particularly those that would roll back some of Dodd-Frank's consumer protections.

Secretary LEW. You know, Senator, I think that if you look at the financial crisis and where the kind of root cause of the financial crisis was, a lot of it started with individuals entering into mortgages that were being sold to them on terms that could not be understood by a normal human being getting a mortgage. And then the financial crisis hit, and all these mortgages were exploding.

We have created a set of protections for consumers now which I think will make it almost impossible for that to happen again. We have much clearer documentation. We have much simpler documentation. We have more disclosure. We have prohibitions on some of the most dangerous practices, you know, things that—the low-doc, no-doc loans and, you know, balloon payments that you could not really see that were in the documents.

And I think if you take away those kinds of consumer protections, you are exposing individuals to a great deal of risk, which is one problem. You are also reopening the possibility of a broader set of systemic risks.

So I think that these are important things that we have accomplished through Dodd-Frank and the implementation of Dodd-Frank, and, you know, the Consumer Financial Protection agency has done, I think, a tremendous job taking these issues and putting them in place in a way where actually, as you talk to people in the industry as well as consumer advocates, there is a lot of respect for the way a lot of that was done. And I think, you know, rolling that back would be a mistake.

We have made clear that any amendments to Dodd-Frank that undermine the core provisions of Dodd-Frank are just not going to be acceptable, and I certainly hope that as the Congress proceeds, it is with a spirit for strengthening financial protection, not weakening it.

Senator BROWN. Thank you, and that is why I am hopeful in discussions on this Committee that we come together in a way that there really is bipartisan consensus not to score political points but to really fix some of the more minor parts of Dodd-Frank on which we have agreement. So thank you for coming today.

Let me talk about yesterday and some other discussions we have had. The Committee has talked about the $50 billion threshold for the Fed's enhanced prudential standards for bank holding companies. What have you heard from industry? Do you believe the agencies can tailor these regulations to address these concerns? Do you believe that we should?

Secretary LEW. Senator, I believe that the law was written with a great deal of flexibility, and it has been implemented with a great deal of flexibility. It is not a one-size-fits-all approach. I think that $200 million financial institutions are different than $50 billion institutions, which are different from $2 trillion institutions.

You know, I think if you look at the work that the regulators are doing, they are open to the ideas of using that flexibility to provide the kind of nuanced approach that the law envisioned.

I think it is premature to legislate in this area because I think there still is regulatory flexibility, and the regulators have shown a desire and an interest in using that flexibility.

I would also say that we have to be careful to assume that there is only risk above a certain size. We have seen financial crises come from large institutions, and we have seen them come from smaller institutions. And we should not be overregulating small institutions that do not present risk. But if there are issues of risk, we ought to not just say that because an institution is X dollars that risk is not there.

Senator BROWN. Thank you. One final issue. Last year, we discussed concerns that I and a number on this Committee had about financial deregulation and disarmament, if you will, through international agreements. I am especially worried that including financial services in the TTIP, the Transatlantic Trade and Investment Partnership, could undermine U.S. financial regulations. Last year and in your testimony before the House Committee last week, you stood firm in not including financial services in TTIP. I urge you to continue that advocacy in international negotiations to preserve our regulators' authority to do whatever is necessary to make sure that this financial system, which you have worked so hard to make safer and sounder, will—you will be consistent in that.

Secretary LEW. Senator, I can assure you that I have reiterated that view with the new leadership in Europe. They have changed over who is responsible for this. I met with Lord Hill recently. So I have reiterated our very strong view that prudential regulation ought not to be subject to review in a trade context.

Chairman SHELBY. Senator Corker.

Secretary LEW. On the other hand, we do believe market access is an appropriate issue to be addressed in the trade context.

Chairman SHELBY. Senator Corker.

Senator CORKER. Thank you, Mr. Chairman. I appreciate it. Mr. Secretary, thank you for being here and for your service.

Let me ask you, would you consider Freddie and Fannie or GSEs to be systemically important?

Secretary LEW. Senator, I think that there is no doubt but that when you look at the financial crisis in 2007–08, they were——

Senator CORKER. A "yes" will work.

Secretary LEW. The question of using a label until it has been reviewed is one I am going to avoid.

Senator CORKER. I do not mean definitionally, but it is certainly systemically very important. Is that correct?

Secretary LEW. I think there is no doubt that the GSEs were at the heart of the last financial crisis.

Senator CORKER. And at present, we are in essence controlling 100 percent of them. We are guaranteeing every single security, our Federal Government is, that they offer. Is that correct?

Secretary LEW. Well, as long as they are in conservatorship, yes.

Senator CORKER. And as I understand it, the administration has no plans whatsoever to sell off our preferred shares and IPO them. You are waiting for Congress to act. Is that——

Secretary LEW. Well, Senator, as you know, we worked closely, as you and others were developing legislative proposals in this area. We believe it is important for there to be legislation, and GSE reform can only really happen properly through legislation. We are using the tools we have to manage effectively in the interim, but I think taxpayers are exposed to the risk still.

Senator CORKER. A hundred percent.

Secretary LEW. And GSE reform is the answer to it.

Senator CORKER. And every single security they issue, the taxpayer is on the line for, right? Because we are standing behind what they are doing. They could not sell a security without the eagle stamp. Is that correct?

Secretary LEW. Now, I will say that they are under heightened supervision compared to before the financial crisis, so the practices are different, and a lot of the laws that we have put in place and the FHFA oversight is meaningful. But fundamentally, as long as they are in conservatorship, there is a guarantee.

Senator CORKER. So we certainly have an explicit, explicit, explicit guarantee because we as taxpayers are guaranteeing everything they are doing.

Secretary LEW. And I know that I do not need to tell you this because you put so much time and effort into the issue of housing finance reform, but the process of defining what exposure the taxpayer has would limit and contain that risk in a way that it is not without legislation.

Senator CORKER. So, in essence—you sure are taking a lot of my time with your answers. In essence——

Secretary LEW. I was trying to compliment you.

Senator CORKER. Thank you. I do not need it.

[Laughter.]

Senator CORKER. So, you know, in essence, while we do not act, we continue to have a huge liability. And for those who are worried about guarantees, we have the maximum guarantee we could possibly have right now because we are guaranteeing every single thing that they do. And we need to move ahead to deal with that, or we keep this liability on our books. So I appreciate that.

Let me ask you another question. Forget yourself. The FSOC—I know we all debated this FSOC being set up, and I know that you are getting some questions from the Chairman and others, questions that I have also about de-designation and all of those kind of things.

Do you think it would be better, as you sit where you are—you are part of an administration, have not been exactly high levels of cooperation between the branches. Would it be better if we had someone who was not a political appointee as head of FSOC, somebody that truly was more independent, and when that calls it over time—forget yourself. I am sure you believe you are 100 percent independent. But in the future, would it make any sense for us to consider someone other than the Treasury Secretary being the head of FSOC? And keep it fairly short, if you will.

Secretary LEW. If you look back before FSOC, there was no mechanism to have the kind of conversations we have now. You look at how much progress we have made in a fairly short period of time, and you look how central the players are, including the Treasury Secretary, to this process, I think bringing somebody independent in to do it is not necessarily going to lead to a better, more cohesive result.

Coordinating independent regulators is going to be a challenge for whoever chairs the Commission because they each have an independent charter and they each have independent responsibil-

ities. And, you know, I may bring my own unique perspective to this, having been in a coordinating role in other jobs. I think it behooves whoever is Chair, whatever their position is, to be respectful of that independence, but also driving toward a common understanding of where risks are and what actions need to be taken. And I am actually pretty proud of the work that FSOC has done in a short period of time. So I would not be in a rush to make a change like that.

Senator CORKER. If I could just say one last thing, Mr. Chairman, I believe that America should honor its commitments, and I think when we do not do that, we undermine ourselves. And as you know, I have supported us carrying out the IMF reforms that actually began under George Bush that you all have followed through with—or actually have not, and that is the point I want to make. I support those. We have tried to work with the administration to make those happen and just have found it difficult to get the administration to make one phone call in some cases to work out something where Republicans and Democrats could agree with IMF reforms.

I got a letter from you in the last couple days where you said—insinuated that we could do away with the NAB, the line of credit, if we could actually put our quota in place, and I think that would be very helpful if you all would proffer that as a real proposal. But I just have to tell you, as I watched the Asian—the AIIB being formed—I know they have been looking at it for a decade. I got it. But I just think this administration's inability—inability—to competently move ahead and put the Senate and the House in a position to put those reforms in place, because you do not really pursue it aggressively, you do not do the things that you need to do to sell it, I think it damages our country. And I think we are seeing it play out right now, and I could not be more disappointed. And even though I agree with you on the reforms, I just do not think you all are carrying out your responsibilities appropriately.

Secretary LEW. Mr. Chairman, may I just respond briefly?

Chairman SHELBY. Go ahead.

Secretary LEW. Senator, I know that you and I agree on the critical importance of the IMF reforms being approved. I obviously do not agree with your characterization of the administration's efforts. I think we have been pursuing this zealously. It should have happened a long time ago. It should never have been tied to unrelated extraneous political issues. And I think there is a growing understanding now with the Asian Infrastructure Bank's formation of how much it weakens the United States that we have been unable to ratify the IMF reforms, which do not actually commit new resources; it just shifts resources from the New Arrangement to Borrow into the capital fund.

I remain optimistic that we can get it done. We are continuing to press forward. We will continue to press forward. And I think I have made every phone call anyone has even thought about, much less suggested. You know, it has not been for lack of contact. It has not happened yet. It needs to happen, and it needs to happen in a bipartisan way because it is in our country's interest. It hurts the United States every day that it is not ratified.

Chairman SHELBY. Senator Warren.

Senator WARREN. Thank you, Mr. Chairman. Thank you for being here, Mr. Secretary.

You know, a company does not need to be a bank to pose a serious threat to the financial system and to the economy. AIG, Lehman Brothers, Bear Stearns—we learned that lesson the hard way during the financial crisis. And that is why Dodd-Frank gives the Financial Stability Oversight Council the authority to designate nonbanks as "systemically important" and subject them to extra scrutiny by the Federal Reserve.

Now, the whole point of the FSOC designation process is to make the financial system safer, and one way it does that is by imposing higher capital standards and greater oversight on systemically important companies.

But the other way it can make the system safer is by providing an incentive for designated companies to change their structure or their operations so they can reduce the risks that they pose and change their designation and the amount of oversight that they require.

In many ways, the second outcome is even more desirable than the first because it would allow businesses to find the most efficient way of reducing the risks that they pose to the economy.

Secretary Lew, do you think the FSOC designation process currently provides companies with the information and the opportunities they need to make changes in their business activities and potentially reverse the designation as systemically important?

Secretary LEW. Senator, I do. I think if you look at the designation process, there is a huge amount of information that goes back-and-forth between the companies and FSOC, and then there are several hundred pages of analysis which shows where the risk transmission is and what it is related to.

For most of these firms—let us leave the market utilities to the side; they are kind of a special case. But for the complex financial firms that have been subject to designation, they have inherently complex business structures. So it is not necessarily an easy thing to unpack what it would take for them to become—to de-list. But they know—they know what it is that creates the basis for the designation, and——

Senator WARREN. Good. And——

Secretary LEW. ——every year they are reviewed, so it is not like you are designated and we never look again. It is an annual review.

Senator WARREN. Well, let me just ask then about how collaborative the process is. Can companies meet periodically with FSOC staff? Can they appear before the full Council to discuss possible approaches to deleveraging their risk?

Secretary LEW. Well, to date, the appearances before the Council have been at an appeals stage after the designation was initially put before the Council. So it is not an ongoing contact. There is ongoing contact between the firms and the FSOC staff, which I think is appropriate.

Senator WARREN. All right. And I just want to be clear on this, because I want to make sure nobody has any doubts about how this works. Is FSOC willing to reverse the designation of a company if it finds that the company no longer poses systemic risk?

Secretary LEW. That is what the annual review process is all about. Every year you have to make the determination again.

Senator WARREN. So use the magic word here: Yes?

Secretary LEW. Yes.

Senator WARREN. Yes. Good, good. I know that Dodd-Frank also permits FSOC to designate specific activities that companies engage in rather than specific companies as posing significant risks. Is FSOC open to the possibility of reversing designation of a company as high risk and instead designating only certain activities within the company that the company engages in as risky?

Secretary LEW. Well, I am going to have to say that I am not sure I understand what the process that you are describing is. The designation authority applies to the firm. When we are doing an activity review——

Senator WARREN. Well, let me just make sure that we are on the same wavelength on the question. Dodd-Frank also permits not just the designation of a whole firm, but not designating the firm and focusing on a specific portion, a specific activity that the firm engages in.

Secretary LEW. So in our review, for example, of asset managers, we put out a public notice where we ask for comment on our inquiry into an activity review of those firms. We have not yet completed that, so I do not know what form an action would take, if there were any action required. I am also not sure it would be FSOC as opposed to regulatory agency action that would flow from that.

So I think it is hard to answer the question in a simple yes-or-no way. We have gone through the designation process for firms. We have never designated an activity that I am familiar with.

Senator WARREN. All right. It is simply a reminder. Dodd-Frank gives you a lot of flexibility in these circumstances. And if you need it, I just want to be sure that you are there to use it when appropriate.

Secretary LEW. And we think it is very necessary to be looking at activities, which is why we have opened up in the asset manager area the activity review, because, frankly, starting by looking at firms, it seemed like we might miss where the real risk was if we did not look at the activities.

Senator WARREN. So the FSOC designation process is critically important to ensuring the safety of our financial system and guarding against another crisis. I think it is important to recognize that designation can achieve that out by encouraging companies to change their structure or the operations. I am glad FSOC is committed to working with companies to make sure that they can accomplish that alternative results. Thank you, Mr. Secretary.

Chairman SHELBY. Senator Cotton.

Senator COTTON. Thank you, Mr. Secretary, for your time today. I want to follow up on Senator Warren's line of questioning about the FSOC designation process. You said that FSOC can reverse a decision at its—I think you said the annual review.

Secretary LEW. Each of the designations is subject to an annual review after designation, so we have to officially act on that annual review.

Senator COTTON. And you have not done that yet, have you?

Secretary LEW. Well, we have on a number, but it is obviously very early in the process to be going—we have only had the first annual review.

Senator COTTON. So rather than the FSOC changing, modifying, or reversing a decision, what if the designated institution simply disagrees? What recourse does it have?

Secretary LEW. Well, institutions have multiple points of recourse. At the point of designation, they can appeal to the Council itself, and they have recourse to the courts if they continue to want to pursue their appeals.

Senator COTTON. So as with any traditional agency decision, an institution designated as systemically important could just use the Administrative Procedures Act to appeal to a Federal court?

Secretary LEW. They can go to court to challenge the determination, yes.

Senator COTTON. Has that happened yet?

Secretary LEW. There is one pending appeal.

Senator COTTON. OK. Thank you.

The Financial Stability Board, are its decisions binding on the United States?

Secretary LEW. The Financial Stability Board is a deliberative body that sets goals that countries aspire to, but it does not make policy for any of the constituent countries. Each of us has our national authorities that make decisions for the companies that we are responsible for in the economy that we are in.

So we make at FSOC the decision to designate a firm. The FSB cannot designate a firm for us.

Senator COTTON. Is there an instance in which FSOC has deviated from the FSB's statements or policy——

Secretary LEW. I would have to go back and check. Obviously, there is a limited amount of history here because both are relatively new organizations. But I would be happy to get back to you.

Senator COTTON. OK. So the FSOC has issued a notice asking for comments about whether asset management activities can pose systemic risk. I believe that closes out today.

Secretary LEW. I believe today is the deadline.

Senator COTTON. The FSB has moved forward, though, with a proposal that seems to make a number of assumptions that SIFI designation of asset managers or funds is a virtual foregone conclusion. Would you explain, you know, the FSB's announcement and, given the tendency of the FSOC to follow FSB, whether or not this is already a foregone conclusion?

Secretary LEW. No. I mean, I can tell you that there is no foregone conclusion of what the action at FSOC will be. I think if you look at the course that we have taken as we have looked into asset management, it has reflected what I think is the right approach, which is to be data-driven and analytically driven. As we went through the process of thinking about doing it on a firm-by-firm basis, we came to the conclusion that we thought an activities review was the better way to put most of our current energy. We have reserved the right to go to firms. We have not said we are going to go one way or the other. But we indicated that we are putting additional resources into the activity review. The notice that you are describing was the outgrowth of that discussion. We have

not yet even gotten all the comments. So I would never prejudge what our action is until we have done a complete analytic review.

Senator COTTON. OK. While I have you here, I want to ask you a question about Iran and specifically Iran sanctions. Ayatollah Khamenei over the weekend said that all sanctions must be lifted immediately for there to be any agreement with the P5 plus 1. Could you explain to us the administration's position relative to that statement?

Secretary LEW. I think that we have been clear that our sanctions will remain in place until we reach an agreement and will not be removed unless we reach an agreement that assures us that Iran will not be able to get nuclear weapons. Obviously, there is a negotiation going on, so there is not yet an agreement to describe, and I cannot tell you whether it will reach a positive outcome. But I can tell you that there will not be any lifting of sanctions if we do not get an agreement that assures us that Iran will not get nuclear weapons.

Senator COTTON. Well, he had said that for there to be an agreement, sanctions must be lifted. In fact, I think his exact words were, "The lifting of sanctions is part of the agreement, not the outcome of the agreement."

Secretary LEW. Sanctions have always been a means to an end. The goal is to stop Iran from getting nuclear weapons. The time at which sanctions will either be suspended or terminated is subject to negotiation, but it is conditional on reaching a successful end, which means that Iran cannot have nuclear weapons. And that is what they are in place for, and they will not be removed if we do not get that assurance.

Senator COTTON. Subject to negotiations is also subject to congressional action since this Congress created the sanctions in the first place?

Secretary LEW. I think the termination could only be done by congressional action. Obviously, they are implemented pursuant to Executive authority, and there could be a suspension without congressional action but not a termination.

Senator COTTON. How long do you think the President has the authority to suspend those sanctions?

Secretary LEW. I am not aware of its conditions based on a time basis, as best I understand.

Senator COTTON. All right. Thank you. I am over my time.

Chairman SHELBY. Senator Menendez.

Senator MENENDEZ. Thank you, Mr. Chairman. I am tempted almost to follow on that line of questioning, but I am not.

As we saw in the financial crisis, risk can build anywhere in the financial system regardless of the types of entities involved or the jurisdictional boundaries of regulators. And the Wall Street Reform Act established the Financial Stability Oversight Council to identify financial stability risk that may be building in the shadows and bring them to the light to improve coordination and fill in any gaps in supervision. And its most important tool is its power to designate nonbank financial companies for enhanced supervision and regulation. And that is a tool that is both powerful but also one that needs to be appropriately used. So let me ask you some

questions in this regard. I want to follow up Senator Warren's just to make sure I understood your answer.

Earlier this year, FSOC announced an updated procedure for considering possible nonbank SIFI designations, including more engagement earlier in the process when a company is under consideration. So the question is: When FSOC is considering a company for possible designation, to what extent does the updated process allow for a discussion of steps the company can take if it wants to avoid a designation, for example, by reducing its size or modifying its activities?

Secretary LEW. Senator, there is enormous back-and-forth between the firms and FSOC as we go through the analytic process. I think that the revised procedures formalize some things in a way that is helpful, but it was the case before we changed the rules and it is certainly the case going forward.

In the exchange, the analysis of where the risk transmission channels are is discussed. There are very different views presented sometimes by the firms in terms of ways to analyze it. As you analyze where the risks come from, it also shows you, you know, what it is about the structure of the firm that is giving rise to the designation.

It is often in the case of a complex financial firm, the inherent business model, you know, that is the issue. So while there is a path for understanding it, it may or may not be attractive to change some of the basic structure.

Senator MENENDEZ. But if it is not just the entirety of a business model that has to be changed, but if, in fact, a particular size is the trigger that FSOC is looking at, or if it is particularly an individual or series of activities, is there an opportunity for the company, if it chooses to do so—it may not. It may choose to refute your assertion of them being systemically risky. But is there an opportunity for them to modify their activities or size based on its engagement with FSOC where the Council would take into account those steps——

Secretary LEW. Sure.

Senator MENENDEZ. ——if the company sought to do so?

Secretary LEW. Yeah, I mean, it is not—as I said to Senator Warren, it is true not just in the initial review process, but each year there is an annual review of a designated firm, and if a firm changed its business model, its structure so that the risk issues had changed, that could give rise to a de-listing, having the designation removed.

Senator MENENDEZ. Is it possible before—let us say you have not designated a company yet, and you identify that, in fact, here is why we are looking to—we may be listing you, can the company before you get to that point say, "Well, wait a minute. If you think X, Y, or Z activity is what is going to create systemic risk, then I want to be able to change the course"?

Secretary LEW. I think it would theoretically be possible. Obviously, as a theoretical matter, it is different than in the real world.

Senator MENENDEZ. I am not looking for theory. I am looking to know if, in fact, there is—what is the use of engaging with a company if it is not to both come to a conclusion as to whether it is systemically risky, what activities are systemically risky, and if it

wishes to avoid the designation because of the consequences that flow from that, give it the opportunity to do so? To me, that is not theoretical. It just makes common sense.

Secretary LEW. So if I can just take one step back, the designation is rarely related to one specific marginal activity. I am not aware of any designation that turns on one marginal activity. It is looking at the entirety of a complex financial institution's actions and the risks created.

In the course of that discussion, the firms understand what it is that is being looked upon as the source of risk. They have the opportunity to offer evidence, A, to contradict that view and to challenge it and give rise to us reaching a different conclusion. And they would also have the ability to change the nature of their business to eliminate the source of risk. And the thing that I am trying to be clear about is that it is not that there is—it would be a mistake, I think, to have kind of a notion of this being a mechanical, mathematical process where there is a number that determines where the risk is. It is a much more complicated review process in there. That is why there is a several-hundred-page analysis that supports the designation. It is not just a mechanical, arithmetic exercise.

Senator MENENDEZ. I get it. I think there is a—one final question, if I may. To the extent that FSOC is considering designating an entity as a nonbank SIFI, a company from a different industry or with a different structure from previous designees or companies historically regulated by the Federal Reserve, what step is the Council taking with the Fed to refine what the consequences of designation would be? And how is the FSOC working with the Fed to make sure its rules and supervision are properly calibrated to the risks identified by FSOC and appropriately tailored to the type of firm that is being proposed to be covered?

Secretary LEW. Senator, I think that the Fed has a fair amount—some flexibility within its existing authorities and with the enactment of legislation, the Collins amendment, they now have additional authority to come up with capital standards that are appropriate for insurance companies, say. And I think it is important that they have the flexibility to do it in a way that is sensible in supervising institutions that have different characters. I do not believe that there are—or one-size-fits-all solutions and the flexibility to treat companies of different size and of different characters differently is a good thing.

Senator BROWN. [Presiding.] Senator Heller.

Senator HELLER. Thank you very much to the Ranking Member. I am just pleased that there is not a nonsourced inaccurate chart here today.

Senator BROWN. Your jokes are better all the time, Senator Heller.

[Laughter.]

Senator HELLER. Mr. Secretary, thank you for being here, and thank you for your time.

Secretary LEW. Nice to be here, Senator.

Senator HELLER. And thanks for your expertise and for everything that you do.

Some of the changes that FSOC made recently for these institutions, obviously like everybody here in this room, they are certainly hearing a lot from their small banks, their medium-sized, the regional size, and obviously the big banks out there. And some of the changes that you did make there, I think it is moving in the right direction.

Secretary LEW. Thank you.

Senator HELLER. And I think others are saying the same thing, that these are good movements, going the right direction. Can I ask you just a series of questions to ask you a little bit more about some of these changes so that when I get these phone calls, I can answer certain questions?

Secretary LEW. Sure.

Senator HELLER. The first one has to do with Stage 2 designation. The changes that you made with FSOC, will it now provide a financial institution under consideration access to all that information before the Stage 2 review? In other words, will they know what the criteria is for Stage 2 review?

Secretary LEW. Senator, I think that the general criteria are clear to all the firms. They are laid out in the rules that were adopted by FSOC. They are not kind of simple, quantitative lines where you are above or below, it is on or off. And I do not think that would be appropriate because there are no two firms that present with exactly the same risk profile. So there are different kinds of firms, and these are complex financial institutions. So it is an iterative process. It is a conversation.

What is consistent is that the analysis is done to look at the different risk transmission channel mechanisms, and the firms very much understand the analysis that we are doing and what factors influence that analysis.

Senator HELLER. Did the recent changes change any of the criteria for Stage 2?

Secretary LEW. It changed the process, not the substantive criteria.

Senator HELLER. Can you say the same thing is true at Stage 3?

Secretary LEW. Well, these were just process—these were not meant to be substantive changes in the sense of what the standards for review are. It was meant to open—it was to address the concerns that firms had, that they wanted to have more interaction in a more formal way earlier in the process.

Senator HELLER. Did any of these changes say that FSOC would provide the primary regulator of any financial institution its full nonpublic basis for designation before FSOC actually voted on it?

Secretary LEW. FSOC has its own independent responsibilities. It consults broadly. It hears from primary regulators. It hears from interested parties. And in the end of the process, it issues a public statement that is rather lengthy. It is like 30, 40 pages of what the basis is. And the party gets hundreds of pages which they are obviously——

Senator HELLER. Is that before or after the designation, though? Before or after the designation?

Secretary LEW. Well, they see the review in its final form after, but they are very much aware of the analysis during the process.

Senator HELLER. Some of these changes that you made recently with the FSOC, are they nonbinding? In other words, can this change in the future?

Secretary LEW. Obviously, rules that are made can be changed. We changed them, I think as you indicated, to respond in what I think is an appropriate way to comments that we received. I think that the effort to make the process more transparent is a good one. I do not think there is going to be——

Senator HELLER. I do, too, by the way.

Secretary LEW. And I do not think that there is going to be any meaningful pressure to go the other way. So while as a technical matter, you know, just like Congress can change the law, the Council can change its procedures. But there is no intention here to be going back and forth.

It is a young organization, 5 years old. It was a good process from the beginning. It has been made stronger. And, you know, I would say that the only changes that I would anticipate are ones that were further refinements and improvements. I just do not hear any debate about kind of going back.

Senator HELLER. I am running out of time, but just real basically, what I am hearing and what the concerns of these financial institutions are is that they do not know if there is an off ramp. In other words, once you are designated, is there a way to get out? They are not certain that there are criteria out there today that they can look at—actually, they do not know what the criteria are to getting designated, let alone how to get out once they are designated and if they are designated. Do you believe you are closer to answering that question with these new changes?

Secretary LEW. Well, Senator, I have tried this afternoon to answer. I think there is an—there is an annual review process. That annual review process is one that is serious and gives rise to the possibility of removing a designation. Obviously, a firm would have to change the character of the risk it presents in order for that change to be made. They have a very clear analysis, hundreds of pages of detail, and if they choose to change their business to address those issues, that would be something the Council would review and could lead to a removal of the designation.

Senator HELLER. Mr. Secretary, thank you.

Thank you, Mr. Chairman.

Senator BROWN. Senator Warner.

Senator WARNER. Thank you, Mr. Chairman. I would like to thank Senator Tester for letting me jump line.

I want to stay in this same vein, and I want to just for the record note as well that the original draft of Title 1 and 2—nothing to do with you, Mr. Secretary; I think you have done a fine job—did have an independent Chair, because the notion of an independent Chair that had sole focus of trying to bring this level of collaboration I think would be important.

I do feel what Senator Heller has mentioned, Senator Menendez has mentioned, Senator Warren has mentioned, and I want to mention is I do not—I think many of the firms, particularly the nonbank financials, you know, those of us who were very involved in Dodd-Frank, there was no intent to create a Hotel California provision. You know, there was always this ability, I think as Sen-

ator Warren said, to de-designate. And I personally believe that, again, new organization, new entity that in these original designations, there was not that lack of—there was a lack of clarity and information sharing that would have allowed a firm to make a determination to sever one type of activity, because as we said earlier, it is not just size. It is activity. And I think your improvements in the process potentially take us a step further down that path. My hope is that we will have some evidence of some firm with this new collaborative process, you know, being able to make the choices and exit out early.

But I would ask—what I would say—what I would wonder is you are saying they have this chance at the end of each annual review. Has any firm started down—perhaps you do not want to designate a specific firm, but has any firm said, "Hey, on the annual review we want out, and we are going to go about the following items" or indicated that intention?

Secretary LEW. Senator, we are so early in the process, firms have not even yet really been subject to the Fed supervision. So we are in the first innings of this process.

I think that the test will come over time as firms think through what the supervisory process means and make the business judgments as to whether or not they want to change their business in order to have the annual review reach the conclusion that they should be de-designated. It was never meant to be, you know, a process that only could go one way. And I think even the early designations give the kind of analysis that firms understand the basis of what they would have to change in order for the annual review——

Senator WARNER. But I think what we, at least this Senator will be watching, because I do think there are firms who have indicated that they would like to find a way out, certain firms have been taking certain actions to appropriately deleverage and shrink in size.

Secretary LEW. It certainly is possible if they do that, yes.

Senator WARNER. Well, again——

Secretary LEW. And I do not mean to be skeptical about it. I just——

Senator WARNER. I know. There are firms that I think are affirmatively saying they are going—would like to go through that process, and hopefully we will see an example of it.

Let me hit a couple of other points since Senator Tester has been patient. I want to go back again as well to Senator Corker's point on GSE reform, and I appreciate the administration's support. I wish we could——

Secretary LEW. I would offer the same compliment, but I got criticized for taking time when I did it before.

Senator WARNER. No, no. I will take it.

[Laughter.]

Senator WARNER. But I do think about the fact of the $5 billion a year that would have been committed, close to $5 billion for low-income, first-time, minority homebuyers that would have been extraordinarily valuable, and the fact that we would have dramatically removed this risk to the taxpayer. Do you have any comment about the Inspector General's recent report about the health of Fannie and Freddie?

Secretary LEW. Look, I think that the potential risk remains there until we have real GSE reform. I think that we are much better off now, in a better position now than we were before, the different kinds of mortgages, different kind of oversight. But it is not a good permanent situation.

Senator WARNER. It is not a good permanent situation, nor——

Secretary LEW. And we need legislation to really fix it, as you know.

Senator WARNER. Neither would recapitalization of the existing entities——

Secretary LEW. You need to recapitalize, you need to define what the Federal exposure is narrowly, and you need to deal with——

Senator WARNER. I am saying I do not think recapitalization would make the right—let me go—because I have been—Senator——

Secretary LEW. No, I do not think recapitalization of these firms, but you need to have firms that are capitalized.

Senator WARNER. Right. You need private capital in.

Secretary LEW. That is right.

Senator WARNER. The last question I would have is as much a comment as a question. My hope was going to be that FSOC was going to not only be something that added additional regulatory structure but in many cases would be that court of last appeal for regulations when you have conflicts between regulatory agencies. So far we have not seen much of that. I hope that would be in its future.

Secretary LEW. You know, I would say this: FSOC does not have the power to tell independent regulators what to do in most of their areas of independent authority. But where it has been given authority to coordinate them, I think we have done it quite effectively. The Volcker rule came out identical from five agencies. There were a lot of people who did not believe that could ever happen. I am not sure it has ever happened before that five independent regulators passed an identical rule out.

There are issues that we do not have the power to write a rule, but you look at something like money market funds, FSOC intervened, and the regulator with authority has taken action, and we are in a better place than we were.

I think there are a lot of issues where we have the ability—half of it is power of persuasion, and we have to be clear that it is not a power of compulsion. And I think that if you think about that kind of—the character of independent regulatory bodies and look at the amount of collaboration and coordination that is going on now compared to 5 years ago, it is a world of difference. And that does not mean everything is exactly where it should be and there is not more work to do. But I think you should be proud of the FSOC actually doing the job that you intended for it to day.

Senator WARNER. Thank you, and thank you to Senator Tester as well.

Chairman SHELBY. [Presiding.] Thank you.

Senator Tester, you have been patient.

Senator TESTER. Thank you, Mr. Chairman. And thank you for being here, Jack. I appreciate the work you do. And just for the record—and I know this is not a hearing about Iran, but I appre-

ciate the administration's willingness to engage on what I think may be the most important issue facing the world today.

Secretary LEW. Thank you.

Senator TESTER. And so please pass that along.

Look, I and others have been concerned about FSOC's transparency in the designation process, so most of my questions will—well, I will not say that. Some of them will.

On the businesses that have been designated so far, do they know why?

Secretary LEW. Yes, Senator, they do know why. I mean, they have engaged in lots of back-and-forth at a staff level, and in the end there is a several-hundred-page analysis that describes where the risk is and the transmission mechanisms or the basis for the determination.

Senator TESTER. So you feel confident that when you designate a business, they know pretty darn——

Secretary LEW. They may not agree, but they——

Senator TESTER. They may not agree, but they——

Secretary LEW. They know why.

Senator TESTER. They know why. So by your answer to Senator Warner's question, we have not been to a point where the reevaluation has taken place. Correct me if I am wrong.

Secretary LEW. We have only been at the earliest stages. Firms go to their first anniversary, but it is before they were even subject to full Fed supervision. So I think we have to kind of just be cognizant of it being very early in the game.

Senator TESTER. I have got that. And from some of—and I am sorry I was not here the whole time, but some of the previous questions dealt with numerical metrics. Let me approach the numerical metrics from a little different way, because I do not—and correct me if—I do not believe you believe in numerical metrics as far as designation goes. Is that correct?

Secretary LEW. Well, I do not think numerical metrics would capture what is unique about each individual firm's complex structure.

Senator TESTER. And then plus, it is my understanding that you did not think that they could change with the markets either. Is that correct? If you had numerical metrics, you would not—and the markets changed, they are very fluid, you would not be able to keep up with that change.

Secretary LEW. I am not so sure if—since I—I do not think that we could just draw a hard line and say the number is the difference between risk or nonrisk, so I do not even get to the change.

Senator TESTER. That is OK. So let me get back to where I was originally going. On the reevaluation—and so you have got a business that has been designated. I am not sure the designation is a plus thing for them. It may be a necessary thing, but it may not be something that they really like. And so do they have the ability, when it comes to redesignation, to—or should I say do you have the ability—if we are not involved with metrics, what do you use to reevaluate?

Secretary LEW. Well, first, something has to have changed. I mean, so a firm would have to come in and show what has changed, and if those changes would have an impact on the analysis that led to the original designation, we would have to go

through the analysis again and make a fresh determination that the risk was still worthy of designation.

Senator TESTER. OK. So it is your belief that the companies know why they were designated, and that when the reevaluation comes around, they would have the ability to change some things if they wanted to lose that designation?

Secretary LEW. Yes. And what I said, Senator, prior to your asking the questions, was that it is not the case that it is just one marginal activity that is the basis for designation. It is——

Senator TESTER. It is multiple——

Secretary LEW. It is the entire complex business structure. So it would really mean making some—in each of the designations we have made, some pretty dramatic decisions about business structure.

Senator TESTER. OK. So now we will go back to the original designations. My staff member told me, I think, that Senator Warren talked about this, and that was whether companies were allowed to meet with voting members individually during a Stage 3 designation vote—before that. And I believe you said no.

Secretary LEW. No, we have left the direct meeting with the Council members to be an appeals process at the end.

Senator TESTER. Right.

Secretary LEW. But a lot of contact with the staff throughout.

Senator TESTER. Yes, but they are appealing to the same people that made the designation, correct?

Secretary LEW. But then they can appeal to the courts if they disagree. So they have an independent appeals route.

Senator TESTER. OK. But let me get back to where I was going, and I do not have a pre-answer for this, but why not allow them to talk?

Secretary LEW. You know, the practice of having a lot of individual conversations that are different conversations while you are going through the process I think would not improve the clarity of the review. I mean, there is an orderliness to the way the information is brought in and analyzed and exchanged. There is an opportunity for the company to come in. And each of us on the Council ultimately makes a judgment based on the shared information that we have.

I do not think that it is common practice in a lot of regulatory agencies for there to be a lot of individual meetings of the decision makers with the parties throughout the process.

Senator TESTER. Yeah, I am not sure—and look, Jack, you are a lot smarter guy than I am. And I am not sure——

Secretary LEW. I would not say that.

Senator TESTER. ——that I am advocating for a lot of individual meetings. But it seems to me communication is really important. Look at what an anvil Congress is. Why? It is because people are talking and nobody is listening. And I think that there is an opportunity not to have a lot of meetings but at least give them the input before—the opportunity for input before the designation.

Secretary LEW. So I totally agree with you about the importance of communication, and the reason we made the changes was to open the process up so that the companies that were under review would feel—would have actual knowledge of what is going on——

Senator TESTER. Right.

Secretary LEW. ——and notice and the ability to engage. Before we made the rules changes, we were doing much of that informally. We formalized and made it more clear. I think that is a good thing.

The line between what we do now and the kind of conversations you are talking about is something we should keep looking at. I am not saying that it is something you could never think about. I just think it would be an unusual process for regulators to do.

Senator TESTER. I got you. I think it could be overblown. But, anyway, I will end where I started. Thank you very much for your work. I very much appreciate it and look forward to working with you, whether it is through this Committee or individually, on making things work right.

Secretary LEW. Thank you, Senator.

Chairman SHELBY. Thank you, Senator Tester.

I have a couple of quick questions, and then I hope in a few minutes we can go to our second panel.

Secretary Lew, I have two quick questions that I would hope you would answer with a simple yes or no. I do not know if you would, but I wish you would.

Secretary LEW. Those are usually the hardest questions, Senator.

Chairman SHELBY. Maybe not for you. Do you agree that the FSOC's designation process should be transparent—you talked about that—objective, driven by rigorous data, and not influenced by outside organizations?

Secretary LEW. I believe that a transparent process is good. I think we should be driven always by data and analysis, and we should be open to information that is appropriate——

Chairman SHELBY. What about influenced by outside stuff that you do not really find in your analysis?

Secretary LEW. I do not think that any of our process is subject to influence other than by facts and analysis.

Chairman SHELBY. OK.

Secretary LEW. The sources of it obviously come from, you know, work that is done inside and coming from the parties.

Chairman SHELBY. Is the U.S., the United States of America, under any obligation to implement decisions or determinations made by the FSB?

Secretary LEW. National authorities retain their authority to make their own decisions. The FSB is an organization that I think helps us to bring global standards up to the high standards the United States has set. But we make our own policy.

Chairman SHELBY. Sure. That is good.

Mr. Secretary, as a matter of policy, which you make, the Government, do you believe that fewer systemically important financial institutions is a good thing?

Let me ask it again. As a matter of policy, do you believe that fewer, rather than more, systemically significant financial institutions is a good thing? In other words, if you did not have so many systemically risky, wouldn't the economy be better?

Secretary LEW. I think that we have the deepest and most liquid financial markets in the world. We have the widest variety of financial institutions, and I think we have to make sure that, regardless of size, our institutions are safe and sound.

Chairman SHELBY. And we want to keep them that way, don't we?

Secretary LEW. Yeah, and we—so I do not have a predisposition of the number of firms we need.

Chairman SHELBY. OK.

Secretary LEW. But whether you are big or you are small, you ought to be safe.

Chairman SHELBY. Under the current law, it is my understanding that a firm has the opportunity "to contest the proposed designation." I think you have indicated that. If they are unsuccessful contesting the Council's decision, would you oppose a statutory process to allow a firm, working with the Council, to avoid the designation before the designation is made final? In other words, give them a chance to work their problems out.

Secretary LEW. I think that in its wisdom Congress created a process for these matters to be decided and resolved and adjudicated, and that process should stand.

Chairman SHELBY. My last question: The designation decisions have, as we all know, a large impact on the subject company and the economy. I believe—and I think you would agree—that such decisions should be justified and supported by empirical evidence and based on rigorous economic analysis.

Does FSOC conduct any economic or cost-benefit analysis prior to making a decision?

Secretary LEW. We do rigorous analysis and only designate firms if the risk determination is made. And I think if you look at the benefits that come from having systemic soundness, it is—you just need to look back to 2000 and 2008 to see what it costs the economy, what it costs taxpayers, working families, when the system collapses. That is hard to take into account on a case-by-case basis, but that is the reason that Dodd-Frank was enacted. It is the reason FSOC was created.

Chairman SHELBY. Is there any reason that you can think of that FSOC could not share all this information with the public, subject to confidentiality concerns of the company?

Secretary LEW. Well, we share quite a lot of information——

Chairman SHELBY. I know that.

Secretary LEW. ——with the public, and I think we have made great efforts to share as much as we can without shutting down a process that requires that we deal with confidential supervisory information. I think transparency is an important goal, but I think in supervisory matters, confidentiality has always been respected and needs to be in this process as well.

Chairman SHELBY. Thank you, Mr. Secretary, very much.

Secretary LEW. Thank you, Mr. Chairman.

Chairman SHELBY. If we can, I would like to go to the next panel. First, we will hear the testimony of Mr. Paul Schott Stevens. He is the president and CEO of the Investment Company Institute. Mr. Stevens is a well-known lawyer and previously served in senior Government positions at the White House and the Defense Department.

Second, we will hear from Mr. Douglas Holtz-Eakin, president of the American Action Forum, no stranger to the Congress. He is an economist, a professor, a former Director of the Congressional

Budget Office, and former Chief Economist of the President's Council of Economic Advisers.

Next we will hear from Mr. Dennis Kelleher, president and CEO of Better Markets. Mr. Kelleher has held several senior positions in the U.S. Senate, most recently as the Chief Counsel and Senior Leadership Adviser to the Chairman of the Senate Democratic Policy Committee.

Finally, we will hear from Mr. Gary Hughes, executive vice president and general counsel of the American Council of Life Insurers. Mr. Hughes has been at ACLI since 1977 and has served as general counsel since 1998.

Gentlemen, we welcome you to the Committee. Your written testimony will be made part of the hearing record, without objection, and we will start with you, Mr. Stevens, to sum up your testimony.

STATEMENT OF PAUL SCHOTT STEVENS, PRESIDENT AND CHIEF EXECUTIVE OFFICER, INVESTMENT COMPANY INSTITUTE

Mr. STEVENS. Thank you, Chairman Shelby, Ranking Member Brown, and Members of the Committee. I am grateful for the opportunity to appear here today to discuss the transparency and accountability of the FSOC.

ICI and its members do understand the importance of appropriate regulation, and we support U.S. and global efforts to enhance stability in the financial system. To this end, however, the FSOC process must and should be understandable to the public, based on empirical analysis that takes into account all the factors specified in the Dodd-Frank Act, and well grounded in the historical record. Such a process would allay any concerns that U.S. stock and bond funds or their managers pose risks to the financial system that require SIFI designation.

Indeed, throughout the 75-year history of the modern fund industry, these funds have exhibited extraordinary stability in comparison to other parts of the financial system, and certainly they did so throughout the recent financial crisis.

Now, is such an open, analytical review in the offing? Unfortunately, the FSOC's current designation process raises several serious concerns in that regard.

First, like other observers, we are concerned that the FSOC is ignoring the range of tools given to it by the Dodd-Frank Act and instead is seeking to use its designation authority broadly. Congress envisioned SIFI designation as a measure designed for rare cases in which an institution poses outsize risk that cannot be remedied through any other regulatory action. The Council's record to date raises serious questions in our mind about its adherence to this statutory construct.

Second, in none of its nonbank SIFI designations has the FSOC explained the basis of its decisions with any particularity. The opacity of the Council's processes and reasoning really means that no one—not the designated firm, other financial institutions, other regulators, the Council, or the public—can understand what activities the FSOC believes are especially risky. This is an odd result as the very object of the exercise is to identify and eliminate or minimize major risks to the financial system.

Third, instead of the rigorous analysis one would expect in connection with significant regulatory action, the FSOC's approach to SIFI designation is predicated on what one member of the FSOC itself has called "implausible, contrived scenarios." Together, the opacity of the process and this conjectural approach to identifying risks have made SIFI designation appear to be a result-oriented exercise in which a single metric—the firm's size—dwarfs all other statutory factors, and mere hypotheses are used to compel a predetermined outcome, i.e., that designation is required.

Presumably, systemic risk must consist of more than just a series of speculative scenarios designed to justify expanding the jurisdiction of the Federal Reserve over large nonbank institutions.

Fourth, the consequences of inappropriate designation would be quite severe, particularly for regulated funds and their investors. The bank-like regulatory remedies set forth in Dodd-Frank would penalize fund shareholders, distort the fund marketplace, and compromise funds' important role in financing a growing economy. It also would institute a conflicted form of regulation. A designated fund or manager would have to serve two masters, with the Fed's focus on preserving banks and the banking system trumping the interests of fund investors who are saving for retirement or other long-term goals.

The Fed's reach actually could be extremely broad. The Financial Stability Board recently proposed thresholds for identifying funds and asset managers that it expects automatically would be considered for SIFI designation. Under these thresholds, more than half—and let me emphasize, Mr. Chairman, more than half—of the assets of U.S.-regulated funds, almost $10 trillion, could be subject to "prudential market regulation" by the Federal Reserve. Similarly, more than half of the assets in 401(k)s and other defined contribution plans could be designated for Fed supervision. We do not believe that any Member of Congress anticipated that the Dodd-Frank Act could give the Fed this extraordinary authority.

Now, how can Congress address these concerns? What we recommend is quite straightforward.

First, the FSOC's recent informal changes to its designation process are a good first step, but more is required. To assure greater predictability and certainty in that process, Congress should codify these changes in statute.

Second, Congress should require the FSOC to allow the primary regulator of a targeted firm an opportunity to address the identified risks prior to final designation. Primary regulators have the necessary authority and greater expertise and flexibility to address these tasks.

Third, a firm targeted for SIFI designation also should have the opportunity to de-risk its business structure or its practices. Such an off-ramp from designation may be the most effective way to address and reduce identified systemic risks.

And, finally, Congress should revisit the remedies proposed for designated nonbank firms, particularly regulated funds and their managers. Let me emphasize we do not believe that funds or fund managers merit SIFI designation, but if the FSOC chooses to designate them nonetheless, then Congress should look to the SEC

and not to the Federal Reserve to conduct enhanced supervision and oversight.

Mr. Chairman, thank you. I look forward to your questions.

Chairman SHELBY. Dr. Holtz-Eakin.

STATEMENT OF DOUGLAS HOLTZ-EAKIN, PRESIDENT, AMERICAN ACTION FORUM

Mr. HOLTZ-EAKIN. Thank you, Mr. Chairman, Ranking Member Brown. It is a privilege to be here today.

Let me make comments in basically three areas: process improvements, many of which will be familiar from the discussion that has preceded; the desire for greater analysis and metrics infused into this process; and, third, the possibility that if the FSOC is unable to make satisfactory progress in those two areas, it may be useful for the Committee to scrutinize the basic mission of the FSOC once again.

The FSOC was created as a macroprudential regulator. Such a regulator's job is to identify systemic risks, measure them appropriately, implement regulation and other steps that will reduce those risks without excessive costs to the economy, and, thus, undertake the basic cost-benefit analysis embedded in regulation.

The process that the FSOC is using right now does not seemingly convey to the participants that information. Firms do not know how they became systemically risky, how much systemic risk they pose, and what factors in their operations contributed to that systemic risk. They accordingly have no way, as was just mentioned, to change their activities and de-risk prior to designation. They are fated, once the examination begins, to be in or out one way or the other.

I think that the steps that have been taken so far in February were good steps, but additional transparency is really needed so there is an understanding about what is going on, that there has to be an ability to de-risk. I think that in assessing risks, it would be useful for the FSOC to incorporate more of the information provided by the primary regulator and defer to their expertise, where appropriate, and it seems not to be done in this case. We have seen the insurance company examples. And I think there has to be a meaningful exit from designation as a SIFI. The annual review is thus far on paper. It has not yet been implemented in a way that we know there is a meaningful exit ramp, and that should be in there.

The second major thing is to actually bring some quantification to the risks posed by institutions and their activities. The first step in that would be to focus on activities as opposed to simply institutions and their size so that we know what activities translate into systemic risks, have them quantify those based on the historical record of risk in marketplaces and liquidity and the other factors that will be important, and that risk analysis should be presented to all participants in a meaningful way so that we have some sense of magnitudes and know when things are more and less risky.

Now, my final point is that if the FSOC, a systemic risk regulator, cannot identify to participants in the process what is a systemic risk and where did it come from, cannot measure it in a meaningful fashion and convey what is a large and small systemic

risk, we cannot possibly know if it is really reducing systemic risk in an efficient fashion, and that is its job. And if we have a regulator that increasingly has command over large pieces of our capital markets that may or may not be fulfilling the basic mission of Congress, I would encourage this Committee to come back in future years and consider whether it is worth having such a thing.

I am deeply concerned that the combination of an ineffective FSOC and the use of the Federal Reserve as the primary regulator by the FSOC will endanger the Fed itself. It has been the finest monetary authority on the planet. Bringing it into this new role where it has not the expertise and not the experience may lead it to come under just increasing external scrutiny and interference, and damaging the independence of the Fed is not something that we think would be the right outcome of an attempt to make the financial markets safer.

Thank you for the chance to be here today, and I look forward to your questions.

Chairman SHELBY. Mr. Kelleher.

STATEMENT OF DENNIS M. KELLEHER, PRESIDENT AND CHIEF EXECUTIVE OFFICER, BETTER MARKETS, INC.

Mr. KELLEHER. Good afternoon, Chairman Shelby, Ranking Member Brown, and Members of the Committee. Thank you for the invitation to testify today. It is a privilege and honor to appear before the Committee.

Too often when talking about financial reform, too many focus on the trees—a particular regulation or industry or firm—and ignore the forest—why we have the law, the regulation in the first place. That context is essential to understand where we are and what, if anything, we need to do.

Here we have a Stability Council to prevent destabilizing surprises and massive bailouts. When we talk about surprises, everybody thinks of AIG, which I will get to in a minute. But what about Goldman Sachs and Morgan Stanley, almost collapsing and bankrupt within days? That was totally an unexpected surprise, but that is what happened in 2008.

On Friday night, September 19, Morgan Stanley called the President of the New York Fed, Tim Geithner, and indicated they would not open on Monday, September 22, 2008. Adding to that shocking surprise, Morgan Stanley told Mr. Geithner that Goldman Sachs was "panicked" because it felt that if Morgan Stanley does not open, "then Goldman Sachs is toast."

The possibility of Morgan Stanley and Goldman Sachs being bankrupt and collapsing into failure on Monday, September 22, 2008, was a very big surprise, and the result to prevent that were massive bailouts by the U.S. Government and taxpayers.

But that was not the only surprise. Also in early September 2008, AIG came to the Federal Government asking for a huge, indeed unlimited bailout. To everyone's surprise, AIG had gambled with hundreds of billions of dollars of derivatives and lost big, and was bankrupt because it did not have the money to cover its gambling losses. So it came to the Federal Government and the U.S. taxpayer with its hand out. It and its counterparties, all the big-

gest banks on Wall Street, including Goldman Sachs, said, "You have to bail out AIG or the entire financial system will collapse."

No one knew it, but AIG was so interconnected with the system that its failure could bring down everything and potentially cause a second Great Depression. So the U.S. Government repeatedly bailed out AIG, ultimately amounting to almost $185 billion.

There were other, even bigger surprises. The $3.7 trillion money market industry was also on the verge of collapse at about the same time as AIG, Morgan Stanley, and Goldman Sachs. That, too, surprised everyone. The result was the same. The United States Treasury bailed out the money market fund industry by putting the full faith and credit of the United States behind the $3.7 trillion industry.

Those are only three examples of many, many surprises and too many bailouts in 2008 and 2009 that no one anticipated.

The Stability Council was created to prevent similar future surprises and bailouts, and that is incredibly important. Why? Because the crash and the bailouts that started with Lehman Brothers, AIG, and money market funds that led to Morgan Stanley and Goldman Sachs and all the other too-big-to-fail firms exploding into the worst financial collapse since the Great Crash of 1929, caused the worst economy since the Great Depression of the 1930s. Indeed, only massive taxpayer and Government bailouts prevented a second Great Depression. Ultimately, that crash and the economic wreckage are going to cost the United States more than $10 trillion, as detailed in a study Better Markets did on the cost of the crisis.

The tens of trillions of dollars reflect massive suffering across our country. Just one example. In late 2009, unemployment and underemployment reached 17 percent. That means that almost 27 million Americans were either out of work or working part-time because they could not find full-time work. And then, of course, there were the lost savings, homes, retirements, small businesses, and so much more.

Preventing that from ever happening again is why there is a Dodd-Frank financial reform law, why there are regulations, why there is a Stability Council, and why its mission is so very important.

In closing, that is why, when we think about FSOC and accountability, we think about accountability to the American people, accountability to those 27 million Americans thrown out of work, accountability to the tens of millions who lost their savings, their retirements, their homes, and so much more. We ask: Is FSOC doing enough fast enough to protect the American people from known and potential threats to the financial stability of the United States? Yes. Deliberatively, thoroughly, carefully, pursuant to as open and transparent a process that has real accountability built in, but the focus has to be on identifying those threats, responding to them, eliminating them, or minimizing them to the greatest extent possible, and protecting the American people.

Thank you, and I look forward to your questions.

Chairman SHELBY. Mr. Hughes.

STATEMENT OF GARY E. HUGHES, EXECUTIVE VICE PRESIDENT AND GENERAL COUNSEL, AMERICAN COUNCIL OF LIFE INSURERS

Mr. HUGHES. Thank you, Mr. Chairman, Ranking Member Brown. We appreciate the opportunity to comment on the FSOC process.

ACLI is the principal trade association for the U.S. life insurance companies, and we include among our members the three insurers that have been designated as systemically important.

We have heard today that FSOC has already made improvements to its process, but we do believe that additional reforms are necessary to assure that the process is really transparent and fair and that it fills the overarching purpose of the Dodd-Frank Act.

Questions that we heard today I think hit the right note here. We should all be striving for a financial marketplace where there are no institutions that pose systemic risk. And to that end, FSOC should embrace a process that employs the correct metrics to assess a companies potential risks and outlines clearly and concisely the factors that will result in designation.

If systemic risks are identified, the company should be given full access to the information upon which FSOC's conclusions are based, and then given the opportunity to challenge any assumptions it believes are in error and, if it wishes, restructure its activities so as to fall on the nonsystemic side of the line. Only then should FSOC make a final designation and trigger Fed oversight, and companies should always be given the necessary information and the ability to exit designated status if changed circumstances warrant.

Unfortunately, the current FSOC process seems more focused on designating companies as systemic than on working constructively with potential designees to avoid having to make such designations in the first instance. And with all due respect to Secretary Lew, I think there was nothing that I heard from him that would change our view that the bias tilts in that direction.

With that in mind, let me summarize our suggestions for improving the FSOC process.

First, FSOC should institute additional procedural safeguards on the front end of the process, and we offer six suggestions in this regard.

One, afford companies that receive a notice of proposed determination full access to the record upon which FSOC's determination are based, and, importantly, that record must provide a sufficient level of detail to enable the company to fairly understand and react to FSOC's analysis and conclusions.

Two, required that FSOC staff initially recommending a company for designation is not the very same staff adjudicating the company's administrative challenge to a potential designation.

Three, in the case of an insurance company, afford greater weight to the views of the FSOC voting member with insurance expertise and accord deference to the insurer's primary State insurance regulator.

Four, providing a company with more than 30 days to initiate a judicial review of a final determination.

Five, staying Federal oversight pending such a judicial review.

And, six, ensuring that FSOC determinations are made independent of international regulatory actions.

Our second overall point: Once a company has been designated as systemic, there should be a more robust and transparent process for potential de-designation. FSOC should provide the company with a clear indication of the factors that would lead to de-designation, enabling the company to understand precisely what changes to its risk profile would be necessary to be deemed nonsystemic.

Third, as is the case with asset managers, we believe FSOC should be required to pursue an activities-based approach with respect to insurance, focusing on the specific activities and practices that may pose systemic risk.

Fourth, FSOC should be required to appropriately apply the material financial distress standard, as set forth in Dodd-Frank. The authorizing statute enumerates 11 factors that could have a bearing on the company's vulnerability to material financial distress. Yet in the case of the insurance designations, FSOC simply made a going-in assumption of material financial distress and then concluded that such distress could be communicated to the broader financial system.

And, finally, FSOC should promulgate the regulations required by Section 170 of Dodd-Frank. These regulations, done in conjunction with the Federal Reserve, could shed additional light on what metrics, standards, or criteria you would operate to categorize a company as nonsystemic.

Mr. Chairman, we believe the best interests of the U.S. financial system will be served by an FSOC designation process that is more transparent and fair than at present, and the reforms we suggest are intended to achieve these objectives. We pledge to work with this Committee and others for that end. Thank you.

Chairman SHELBY. Thank you, Mr. Hughes.

I will ask the following question of all of you. The goal of the FSOC's process I believe should be not to merely expand the regulatory jurisdiction of the Federal Reserve, but to actually reduce systemic risks to our economy. As the Bipartisan Policy Center pointed out in its statement for the record, it would be troubling if no real process emerges to realistically allow a company to become undesignated.

I will start with you, Mr. Stevens—well, I will ask all of you. Do all of you agree, yes or no?

Mr. STEVENS. Yes, I do agree, Mr. Chairman.

Chairman SHELBY. Mr. Holtz-Eakin.

Mr. HOLTZ-EAKIN. I 100 percent agree.

Mr. KELLEHER. I agree with the headline, not the details.

Chairman SHELBY. Mr. Hughes.

Mr. HUGHES. I agree completely.

Chairman SHELBY. Do you believe that FSOC has provided a clear road map for what a designated company should do to reduce its systemic risk and no longer be designated?

Mr. STEVENS. It would probably be best to ask the companies themselves, but I would be very surprised if their answers were "yes."

Chairman SHELBY. Dr. Holtz-Eakin.

Mr. HOLTZ-EAKIN. I do not believe that it has.

Chairman SHELBY. Mr. Kelleher.

Mr. KELLEHER. It cannot.

Mr. HUGHES. Well, that is a good question, and we have had the opportunity to talk to some of the companies that have been designated, and I think they would explain that, no—you know, somebody mentioned—I think it was the Secretary—that there are hundreds of pages of documents floating around. There are. But in reading those hundreds of pages of documents going back and forth between FSOC and the individual companies, there is not clarity on the specifics of why a company got designated. And I think you would find a very high degree of frustration among the companies that have been designated that they are not sure of the exact reasons why they have been designated; they are not sure of the exact steps they could take if they wished to become de-designated.

So, with all due respect to the Secretary, this is not just a situation where companies disagree with conclusions. They do not have enough information to challenge the conclusions that have been drawn.

Chairman SHELBY. Don't the bank regulators at times, when they are evaluating the safety and soundness of a banking institution, kind of give them a warning of what they need to do to their capital standards and everything, Dr. Holtz-Eakin?

Mr. HOLTZ-EAKIN. Absolutely. There is a regular interchange, and it is often quite quantitative in nature, so there is no ambiguity——

Chairman SHELBY. And a lot of them, because of that, work off their problems and become strong again, do they not?

Mr. HOLTZ-EAKIN. Yes, they do.

Chairman SHELBY. Is that fair?

Mr. KELLEHER. Well, of course, those regulators, the banking regulators, have supervisors and hundreds and hundreds of people in those banks on a regular basis to provide that advice and feedback long before something like an FSOC process happens.

Chairman SHELBY. Well, some of these—I am just the using the analogy of the bank regulators letting the bank work off problems and get strong. And I guess should the FSOC provide a better explanation to the public when it disregards such expertise? I am speaking of—the MetLife designation received a scathing dissent by its primary regulator. The Prudential designation was adopted despite the strong dissent by FSOC's resident insurance experts. That is troubling to me. Mr. Hughes?

Mr. HUGHES. Yeah, I think your comment sort of begs the question of to what extent, if at all, is FSOC looking to the primary regulators of these firms for input and advice.

Chairman SHELBY. Or totally ignoring them.

Mr. HUGHES. Yeah, and insurance is an interesting case, and it is the only segment of financial services that does not have a voting seat on FSOC as a regulator. I mean, there is an individual that has insurance expertise. None of the primary regulators that the three companies designated were at the table when the FSOC decisions were made.

Chairman SHELBY. Dr. Holtz-Eakin, if we create a regulatory regime to address systemic risk without identifying what creates systemic risk, we force companies to guess what might trigger addi-

tional regulatory concern. In other words, they are kind of in the dark. I believe companies must then manage their business models to the worst-case scenario rather than ordinary business. Generally, such uncertainty creates additional cost for them and for our economy, causing companies not to invest in new business opportunities or infrastructure.

My question is this: Should we be concerned that such uncertainty is stifling our economic growth? You are an economist. Are there real costs associated with our regulatory framework and specifically with uncertainty in FSOC's designation?

Mr. HOLTZ-EAKIN. There is increasing evidence that you can trace a straight line between policy uncertainty and economic performance. There has been excellent work done by, for example, Steve Davis at the University of Chicago on this topic. The FSOC is an example of this. It is a large, powerful regulator that people have very little understanding about how it makes its decisions, uses what criteria, and as a result—and where it will show up next, in what part of the financial landscape. And that cannot be in and of itself a good thing for growth.

Chairman SHELBY. Mr. Hughes, insurance products—you know this well—especially long-term insurance contracts such as life insurance, face a much different probability for runs and, thus, failure than one would typically fear with banks. We have heard concerns that FSOC's designation process treats these insurance contracts similar to bank assets, but they are different.

Would you discuss the likelihood of a so-called run on insurance products such as life insurance and what such a run would have to look like in order to cause systemic risk?

Mr. HUGHES. Well, I think you are absolutely correct that the dynamics of a insurance company are much different than those of a commercial bank, certainly in terms of the types of products and the likelihood of money going out the door. I know one of the dissents to one of the designations pointed out, quite correctly, that insurance regulators have the absolute authority to prevent people from turning in their policies, if that is warranted. But I think the experience of the recent economic crisis is very telling in this respect. In fact, it was just the opposite of a run. The products were so desirable in terms of the guarantees they made that, notwithstanding the crisis, people were holding onto those products no matter what.

Chairman SHELBY. Senator Brown.

Senator BROWN. Thank you, Mr. Chairman. I do not think the FSOC designation is quite the black box and mysterious process that some have made it out to be. You know, we start off with metrics, Step 1 and Step 2, six categories, and while we do not necessarily—I think the companies give this information. I assume it is proprietary. We have not seen it, but it is perhaps a little more specific, and companies are a little more aware than maybe we like to think they are.

Let me start with Mr. Kelleher, if I could. We hear from industry that new rules for banks, Basel III, for example, will force some activities into the "unregulated" shadow banking sector. The industry made similar arguments before the crisis, sort of the time period

you were laying out for us, when they used charter shopping to engage regulators in a race to the bottom.

Talk about, if you would, Mr. Kelleher, the role that FSOC plays in ensuring that there are strong standards across the board, that there is a level playing field even for institutions that attempt to operate more in the shadows.

Mr. KELLEHER. There are two key roles that FSOC plays in connection with the shadow banking system and the other problems you have identified. Number one, and most importantly, FSOC was, in fact, created to ensure that we did not have another shadow banking system grow up. In the past, as you both know well, we had banking regulation, and then what everybody did is they moved their activities or their forum in a way so that they did not fall narrowly within banking regulation. And that was the shadow banking system, also known as the unregulated finance system.

So we have a banking regulatory system that identifies banks and bank holding companies for heightened prudential standards and otherwise, as you have heard over the last week in your hearings. And the other arena, which used to be called "the shadow banking system," we have FSOC, which is supposed to be able to identify known and emerging risks as well as designate nonbank financial firms that pose a threat to the financial stability of the country. That is aimed directly at the shadow banking system.

The second piece of your question about charter shopping and the problems one has with siloed regulators is by having a council of regulators, you force them to look at the broader landscape and also to be less captured, not in the pejorative sense of the revolving door but cognitively captured about where you sit is where you stand. And I actually think it is an example of how the FSOC is working well to see that the insurance regulators actually laid out their dissents and dissented, but nonetheless the collective wisdom of FSOC saw and understood the threat that came out of that arena and designated insurance firms nonetheless having gone through the process. And, by the way, they did get roughly 400 pages detailing the designation.

Senator BROWN. Thank you. Mr. Kelleher, your testimony discussed some of the so-called reform proposals. Talk about some of those coming from the House these days or that the House is looking at now.

Mr. KELLEHER. Well, you know, most of the reform proposals at the end of the day are burden delay and future litigation. What we ought to be doing is building up a robust designation process, an FSOC council that really does its job, and I am a little surprised that Doug and others have not taken credit for the dramatic steps forward that FSOC has taken most recently on the transparency and process side, because about half of your recommendations are now incorporated in FSOC's procedures.

Now, everybody does not get everything they want in this town. I think 50 percent is pretty good. But most of these things, whether it is cures, off ramps, kind of a formalistic, one-size-fits-all, quantitative formula, relying on a primary regulator, almost every single one of those so-called reforms are really a step back to procedures that were in place prior to the crisis, and in many respects enabled the crisis.

Senator BROWN. All right. Thank you.

Mr. Kelleher, in your experience with financial regulators, have you ever encountered a regulator that was willing to receive input and criticism from stakeholders and then modified its policies in response to that criticism, as FSOC did in February?

Mr. KELLEHER. You know, I think it is unprecedented. We have gone around and tried to look at this to find an agency that has been criticized, constructively or otherwise, and then gone through an elaborate process to bring the critics in, listen to them, get detailed inputs, and then actually change their process in very meaningful ways in part by, as I said, adopting many of the recommendations of those who had the input. Not only is it unprecedented, I think it shows that this Committee is actually working the way exactly as it is designed. It is not even 5 years old. It is not exactly running around designating everybody who walks by Treasury. In 5 years, we have got four companies. Two of them were no-brainers—AIG and GE. OK. The others, frankly, I think we are going to find out, when the MetLife litigation is done, that they were no-brainers, too.

So what we have is a Council that is doing its job. It is listening to people. It is incorporating changes and making meaningful changes. I think we ought to let them do their job, let the changes set in, and let us see where we are in a year or two, complemented by robust congressional oversight, which you all have been doing. They are doing well. They are trying to do better. And Doug and others who are making some good suggestions are having a meaningful impact.

Senator BROWN. Thank you.

Thank you, Mr. Chairman.

Chairman SHELBY. Senator Warren.

Senator WARREN. Thank you, Mr. Chairman. Thank you all for being here today.

Seven years ago, giant financial institutions like AIG and Lehman Brothers—institutions that were not banks—were at the center of the financial crisis. Congress recognized that while there were regulatory agencies responsible for overseeing specific banks or specific parts of banks, we did not have a single group that was responsible for looking out across the entire system, including the nonbanks, and spotting the risks that they presented. That is why Congress created FSOC and why Congress gave FSOC the power to designate nonbanks as systemically important if they met certain basic criteria.

Now, there has been a lot of discussion today about potential flaws in the designation process, and I just want to focus on a few of those. I have heard people who represent the insurance industry claim that certain kinds of companies, like insurance companies, simply cannot pose the kinds of systemic risks that banks do.

Mr. Kelleher, do you think that large insurance companies can pose systemic risk?

Mr. KELLEHER. Well, I do not think there is any question that large insurance companies can pose systemic risk. I mean, we only have to look at AIG and see what happened there, which was, after all, an insurance company. And let us remember, MetLife, before it sold off its deposits a couple years ago, it was one of the largest

bank holding companies in the United States at the time. So insurance companies, the big, large, complex, global insurance companies, certainly can be, and they should be, if appropriate, according to the criteria, subject to the designation process and designation if, after that process, they are deemed to meet the criteria.

Senator WARREN. Thank you.

Now, another argument I have heard today is that the designation process is flawed because it does not weigh the costs and benefits of designating a company. Mr. Kelleher, do you think that imposing some kind of cost-benefit analysis is a workable approach here?

Mr. KELLEHER. The so-called cost-benefit analysis is almost always translated into an industry-cost-only analysis, and we have seen that at the other agencies and other places where the industry has tried to impose what they call "cost-benefit analysis."

It really takes into account too often, and as designed, industry's quantifiable costs where, you know, they exaggerate them and they pile them up a mile high with virtually no basis and say the sky is going to fall, it is going to cost us $62 billion, or some fabulous number. What they never do is to take into account the often unquantifiable, sometimes quantifiable benefit to the public.

For example, what is the benefit and how do you quantify the benefit of avoiding a second Great Depression or, for example, 27 million Americans out of work in October of 2009? And we could go through the list—and it is a long list—of the economic wreckage inflicted on the American people by the last financial collapse. That is FSOC's duty to prevent that happening again.

How you quantify it and how you quantify it, as Secretary Lew said, on a case-by-case basis is virtually impossible, and that is why it is so grossly inappropriate to be trying to apply industry-cost-only analysis on financial regulation and protecting the American people.

Senator WARREN. Thank you, very much. I agree with this. I have often wondered how the regulators would calculate the benefits of avoiding another financial crisis—a financial crisis that sucked, what is it, $14 trillion out of the U.S. economy?

Mr. KELLEHER. Probably more.

Senator WARREN. Probably more. All right. Let us do the third one then. I have heard that the designation process is not transparent, and I am all for increased transparency, but I assume the Council must balance transparency against disclosing confidential or potentially market-moving information.

Mr. Kelleher, do you think FSOC has struck roughly the right balance with recent changes to the designation process?

Mr. KELLEHER. I should start by saying Better Markets stands for transparency, accountability, and oversight. There are few things that we prioritize more than transparency, and we have actually been very critical of FSOC over time for their lack of transparency. But I will say that they have made tremendous strides recently. I think that they actually did a good job before, and they were not transparent about it; and, therefore, that is what raised a lot of the questions. They are now moving to a much more transparent process and a more involved process that I think is only going to strengthen those processes.

Reasonable people can disagree where on the line you have transparency from total public transparency to protecting confidential information and deliberative ability of the Council. But it looks to me that they are both at the right place and moving in the right direction. And as I say, adopting many of the criticisms as part of their procedures now to open it up I think is a pretty clear signal and an unprecedented signal, as I said to Senator Brown, that we have a Council that is really committed to getting this right and being maximally open.

Senator WARREN. And I take it, Dr. Holtz-Eakin, that you would agree that they have at least moved in the right direction.

Mr. HOLTZ-EAKIN. Certainly. In both my written and oral statements, I said so.

Senator WARREN. Good. Thank you.

The FSOC designation process is obviously a work in progress. I think the Council has generally gotten it right and has demonstrated a willingness to work with members of the industry and others to improve aspects of the process, and I trust that that will continue.

Thank you, Mr. Chairman.

Chairman SHELBY. Dr. Holtz-Eakin, would you like an opportunity to respond to Senator Warren's question on cost-benefit analysis—I have been bringing that up a long time—since you are an economist?

Mr. HOLTZ-EAKIN. Well, certainly. I mean, we require benefit-cost analysis in lots of other regulatory settings because it is information that should be imbued in the process. That does not mean that measuring benefits and costs is easy. In many cases it is not. Measuring environmental benefits is a notoriously difficult task. Measuring increased human safety in the workplace is a notoriously difficult task. None of this has stopped the agencies from undergoing the discipline of having to write down the things that might be benefits, the things that might be costs, and making a good-faith effort to add them up. The FSOC should do the same.

Chairman SHELBY. Thank you, gentlemen.

You have a question?

Senator BROWN. Could I follow up on that? Dr. Holtz-Eakin, do you think we could have quantified—or how would we have quantified in 2006 and 2007 or even the earlier years in that decade on some of the things that some of the regulators did? Could we have quantified the cost to society of what happened in 2008 and 2009? Do you think as we did some of those deregulation activities or some of the regulation activities that you could have really figured out—you could have figured out the cost to the companies, to be sure, but could you have figured out the cost to society which I guess would be on the benefit side of the equation very accurately?

Mr. HOLTZ-EAKIN. Recessions avoided are benefits. There is no question about that. But in any circumstance you can certainly do a disciplined job of adding up the costs, economic costs, not just industry costs. And I would suggest to Dr. Kelleher that if the FSOC is going to have good processes and everything else, and he has great faith in that, they can get a good process on calculating economic costs.

So let us suppose they do that. Well, then, we will know how big the benefits have to be at a minimum in order to for something to be worthwhile, and getting that order of magnitude right is important to know, I think. And then you can in formal ways do analysis of what economic performance looks like with and without access to intermediation and credit, which is exactly what happened in 2008 and 2009. We had an enormous liquidity crunch, and it dried up the ability for people to get financing. You can translate that into declines in investment and employment. You can look at the costs.

Senator BROWN. Yes, it is just hard for me to think that, without being laughed at, if any public interest lawyers or the agencies would have said here is what potentially could happen if we weakened or deregulated some of the things OCC did or the Fed, that we possibly could have predicted that, and that is why I am a little bit jittery about this whole structured cost-benefit, even though I think we should do cost-benefit in a whole lot of ways. I just do not think that—there needs to be some caution and the other side needs to be weighed perhaps a little better than it has been.

Mr. HOLTZ-EAKIN. I take your point. I would just point out that there are a lot of things that presumably FSOC is supposed to do that my experience on the Financial Crisis Inquiry Commission suggests it is just not going to work. So take the AIG example. The fundamental problem with AIG is that the CFO testified under oath that he as the chief risk officer and the chief liquidity risk officer was unaware that their contracts required them to post collateral if the underlying securities declined in value. There is no way the FSOC is going to be able to identify in advance utter managerial incompetence. That is joke to run a major company and not understand your own contracts and you are unable to comply with them. There is nothing about the FSOC that is going to stop that.

And so for big structural things that you can quantify, do benefit-cost, you should do it, but do not—I am just far less sanguine that somehow this entity is going to be so nimble that it is going to find all these things. It just will not.

Mr. KELLEHER. Well, of course, its job is not to find those things. What the real analysis is——

Mr. HOLTZ-EAKIN. Well, in your testimony you suggested exactly that, but it will not.

Mr. KELLEHER. But the real question is—let us say that in 2005 AIG was then subject to cost-benefit analysis and a designation process. First of all, we know no one anticipated AIG happening, the money market fund failure happening, anticipating any of that. So the ability to anticipate the cost and benefit associated with designating any one of those firms before the last crisis we know for a fact is actually impossible.

So AIG would not have been designated because you would not—it would never have been designated if you had a cost-benefit analysis requirement in 2005. It has got nothing to do with managerial competence or incompetence. And one person did testify as to that, Doug, but you well know that there is much other testimony as to why it is AIG failed, and it was not merely missing the collateral calls.

Chairman SHELBY. Earlier, some of you were here, I believe, when Secretary of the Treasury Lew—I asked him if he would oppose a statutory process to allow a firm working with the Council to avoid the designation before the designation was made final. Surprisingly, he said he would oppose such a process. That was my understanding.

Assuming that is what he said—and I think it was—why would the administration not support a process whereby we would have fewer systemically risky firms? Do you have any idea?

Mr. STEVENS. Well, as you know, Mr. Chairman, our testimony indicates that allowing a firm at that point to de-risk, that is, to address those circumstances, activities, aspects of its business model that are raising outsize risk to the financial system will probably be the quickest and most effective way of dealing with the risk that the Council perceives rather than supervising it through the Fed and admiring the problem any further. We absolutely believe that is a reasonable additional——

Chairman SHELBY. I do, too.

Mr. STEVENS. ——requirement or authority under the statute.

Chairman SHELBY. Doctor, do you agree with that?

Mr. HOLTZ-EAKIN. I agree with that, and there is an additional benefit in that other firms watching the process can now have visible demonstrations of what it takes to avoid designation, modify their activities in advance, and generate a safer system.

Chairman SHELBY. Mr. Kelleher.

Mr. KELLEHER. Two thoughts. First of all, I think that the companies being looked at have a much better, deeper, and actually nuanced understanding of why they are raising the risks, what those risks are, and why they are getting designated.

What these requests really are getting to is they would like a road map that is basically a one-size-fits-all check-the-box so that they can try and get out of the designation. What we need, though, is what we have, which is a process that allows us to evolve as risks evolve, business activities and markets evolve. And I am surprised that some of the entities and people actually suggesting that a Government agency should work with a private company almost in a consulting capacity to suggest how they could modify their business practices to reduce their risk.

The company knows what the risks are. If they choose to make those business decisions and de-risk, then they can ask to be de-designated, and there is a full process for de-designation.

Chairman SHELBY. But banks, they do it all the time.

Mr. KELLEHER. With all due respect, Mr. Chairman—and you know better than I know the process for supervision of banks, and the way the Fed and the FDIC supervise banks literally on a daily process and an ongoing process, that with thousands and thousands of employees, they are in a position to look at the loan book and how the loan book is working and how to give advice as to where the risks are coming under the CAMEL reports. That is not the role of FSOC, and that is not the role of FSOC as decided by the Congress and executive branch when they passed the law. To put the FSOC in the business of working with private companies to help de-risk them strikes me as a rather dramatic change and maybe unprecedented for a Government agency.

So I am often surprised when I see my friends who are often accused to be of a different political persuasion than I am suggesting such involvement in the private sector.

Mr. STEVENS. Mr. Chairman, I have tried to be brief, but could I add one further thing?

Chairman SHELBY. Absolutely.

Mr. STEVENS. I was struck by Secretary Lew's comment, and what I conclude from it is that the resistance to the idea of de-risking, either by the primary regulator or by the firm, is that the FSOC would not know exactly what to tell them as to how to go about that. And that is the reason for the lack of specificity in their determinations, and it is, frankly, the reason that—what this really boils down to is size is the single metric. That is the metric that is coming out of the Financial Stability Board with respect to funds of the sort that our members offer: $100 billion, you are systemically important; $1 trillion by a manager, you are systemically important. The analysis will end and begin there.

Chairman SHELBY. Mr. Hughes, I did not give you a chance on that.

Mr. HUGHES. Yeah, I heard the same thing when the Secretary testified, and I guess I am sitting here scratching my head a little bit as to why a goal of this entire process should not be to have a system where there are not systemically important institutions. And if an organization like FSOC can put itself in a position to work with those institutions to de-risk further—I mean, you gave the example of MetLife de-banking. Obviously that was not enough from the perspective of FSOC. And I do not understand the problem with if the goal is to have no institutions that are systemically important, which I think it should be, why wouldn't FSOC work with these institutions? And I think that the answer is, well, these are nonbanks, they are very complex, so, gee, we will just assume that they have material financial risks and then we will take it from there. That is not the right approach.

Chairman SHELBY. Is it lack of knowledge on their part of insurance companies?

Mr. HUGHES. Well, you know, you mentioned that FSOC voted with its collective wisdom. With all due respect to the members of FSOC, there is not a whole lot of deep insurance expertise on the Council. And we have been working with the Federal Reserve on capital standards. To their credit, they are on a steep learning curve, but there is still a long way to go.

So the frustration is that people with insurance expertise said, "We do not agree with the decision," and then the collective wisdom——

Chairman SHELBY. That is why they dissented, did they not?

Mr. HUGHES. Correct. And then the people that do not have the depth of knowledge said, well, let us just say they are systemic and——

Chairman SHELBY. Well, I think we all want strong insurance companies, strong banks. We want all of that.

Dr. Holtz-Eakin.

Mr. HOLTZ-EAKIN. I do not think it is fair to call this a consulting exercise. You know, firms are aware of their risks. They know their portfolio risk, their liquidity risk, their counterparty risk. They

know their leverage. It is in their business interest to have a full command of those risk management tools.

Chairman SHELBY. Absolutely.

Mr. HOLTZ-EAKIN. What they do not know is the magic potion where you mix those up and deliver one ounce of systemic risk. And all they are asking is for some guidance on that so that they can reduce the risk the FSOC is tasked with controlling. That could be qualitative. It could say out of those six categories, this is the most important, this is second, this is third. It could be quantitative. But it cannot be zero.

Chairman SHELBY. Well, I think they should not be able to game the evaluation, you know, of designation, but they should know what the criteria is to where they can operate a sound and safe institution. Do you all agree with that?

[Witnesses nodding.]

Chairman SHELBY. Gentlemen, thank you very much for your testimony and your patience here today. The Committee is adjourned.

[Whereupon, at 4:07 p.m., the hearing was adjourned.]

[Prepared statements, responses to written questions, and additional material supplied for the record follow:]

PREPARED STATEMENT OF JACOB J. LEW

SECRETARY, DEPARTMENT OF THE TREASURY

MARCH 25, 2015

Chairman Shelby, Ranking Member Brown, and Members of the Committee, thank you for inviting me here today to discuss the Financial Stability Oversight Council's nonbank financial company designations process.

As no one here needs reminding, the financial crisis caused great hardship for millions of individuals and families in communities throughout the country, and revealed some central shortcomings of our financial regulatory framework. We witnessed the effects of lax regulation and supervision for financial firms like Lehman Brothers and AIG. These names have already been written into history as companies whose failure, or near failure, helped contribute to the near-collapse of the financial system. At the time, the regulatory structure was ill-equipped to oversee these large, complex, interconnected financial companies. This outdated structure also meant that regulators had limited tools to protect the financial system from the failure of these companies. As a result, the American taxpayer had to step in with unprecedented actions to stop the financial system from collapsing.

Congress responded with an historic and comprehensive set of financial reforms—the Dodd-Frank Wall Street Reform and Consumer Protection Act—to put in place critical reforms for taxpayers, investors, and consumers. The aim of this reform is to guard against future crises while making sure taxpayers are never again put at risk for the failure of a financial institution.

To lead the effort to better protect taxpayers, Wall Street Reform created FSOC. FSOC is the first forum for the entire financial regulatory community to come together, identify risks in the financial system, and work collaboratively to respond to potential threats to financial stability. Over the past 5 years, FSOC has demonstrated a sustained commitment to working collaboratively to fulfill its statutory mission in a transparent and accountable manner. This work has not been easy; we built a new organization and developed strong working relationships among FSOC members and their staffs to allow the types of candid conversations, exchange of confidential, market sensitive information, and tough questions that will make our financial system safer.

Today, FSOC convenes regularly to monitor market developments, to consider a wide range of potential risks to financial stability, and, when necessary, to take action to protect the American people against potential threats to the financial system. Our approach from day one has been data-driven and deliberative, while providing the public with as much transparency as possible regarding our actions and views. We have published four annual reports that describe our past work and future priorities; regularly opened FSOC meetings to the public; published minutes of all of our meetings that include a record of every vote the FSOC has ever taken; and solicited public input on both our processes and areas of potential risk.

I and the other members nonetheless recognize that FSOC is a young organization that should be open to changes to its procedures when good ideas are raised by stakeholders. Just over the last year alone, FSOC has enhanced its transparency policy, strengthened its internal governance, solicited public comment on potential risks from asset management products and activities, and adopted refinements to its nonbank financial company designations process.

I believe that our adoption of these changes to the nonbank financial company designations process represents a prime example of the way FSOC should go about refining its processes without compromising its fundamental ability to conduct its work. Last year, prior to making any changes, FSOC conducted extensive outreach with a wide range of stakeholders. The FSOC Deputies Committee—senior staff who coordinate FSOC activities—hosted a series of meetings in November with more than 20 trade groups, companies, consumer advocates, and public interest organizations. We also solicited input from each of the three companies then subject to a designation. FSOC discussed the findings from this outreach and proposed changes during a public meeting in January.

FSOC adopted a set of supplemental procedures last month. These changes address the areas that stakeholders were most interested in and formalized a number of existing FSOC practices regarding engagement with companies. Under the new procedures, companies will know early in the process where they stand, and they will have earlier opportunities to provide input. Additionally, the changes will provide the public with additional information about the process, while still allowing FSOC to meet its obligation to protect sensitive, nonpublic materials. And finally, FSOC will provide companies with a clearer and more robust annual review process. This will open the door to more engagement with FSOC following a designation to

make sure there is ample opportunity to discuss and address any specific issues that a company wants to put before the FSOC. These changes strengthen the FSOC's process while also addressing many of the suggestions made from stakeholders.

Despite our responsiveness and willingness to engage with stakeholders in this case and others—but perhaps due in part to our successful pursuit of our mission—some opponents of reform have been trying to undermine the FSOC, its members and its ability to respond to potential threats to financial stability. Many of the arguments levied at FSOC are not based on the actual record, and opponents object to our efforts to bring regulators together to work collaboratively to monitor risks and protect the U.S. financial system. But Congress gave FSOC a clear mission to address the kinds of risks and regulatory gaps that resulted in the financial crisis, and we are doing what Congress asked us to do, using the tools Congress gave us.

I am pleased to report to this Committee that the vast majority of key reforms contained in Wall Street Reform are now in place, due to the hard work and diligence of the independent regulatory agencies. We have made substantial progress since the law's enactment almost 5 years ago toward shaping a financial system that is safer, more resilient, and supportive of long-term economic growth. I would like to take a moment to briefly highlight some key milestones that illustrate the scope and significance of Wall Street Reform.

- Regulators now have tools to address the riskiness of the largest, most complex firms—whether banks or nonbanks—in a manner that is commensurate with their systemic footprint.
- In addition, resolution planning and the orderly liquidation authority—a tool that Members on both sides of the aisle in this Committee helped craft—give us the ability to allow any financial firm to fail without putting the rest of the financial system at risk, and—just as importantly—without imposing costs on U.S. taxpayers.
- The previously unregulated swaps market, notionally valued at around $600 trillion dollars, has been fundamentally transformed through the introduction of a comprehensive regulatory regime that is making these markets safer and more transparent.
- The Volcker Rule, which was adopted in late 2013 and is scheduled to take effect this summer, prohibits banks from speculative short-term trading and fund investing for their own accounts. This important rule will reduce both the incentive and ability of banks to take excessive risks, and limit conflicts of interest.
- And with creation of the CFPB, we now have a financial regulator dedicated to looking out for consumers and protecting them from deceptive, unfair, and abusive practices by mortgage originators, payday lenders, and debt collectors, to name a few. To date, CFPB enforcement actions have resulted more than $5 billion in relief to 15 million consumers who have been harmed by illegal practices.
- Other recently completed reforms include: implementing enhanced prudential standards for the largest U.S. bank holding companies and for foreign banking organizations operating in the United States; new rules requiring banking organizations to hold sufficient liquidity buffers; establishing financial sector concentration limits, which set a cap on growth by acquisition for the largest financial companies; risk retention requirements for asset-backed securitizations; and enhanced leverage requirements to strengthen and backstop firms' risk-based capital standards.
- Finally, enhanced prudential standards continue to be applied in a manner that focuses the most stringent requirements on those few firms that pose the greatest risks to financial stability, including a proposed capital surcharge that is proportional to the risks posed by the largest and most complex banks. Also, there is a proposal for a new minimum standard for total loss-absorbing capacity (TLAC). This proposed standard would strengthen the capital framework to help ensure that the largest and most complex banks have sufficient capital to absorb losses, and would help facilitate an orderly resolution in a manner that minimizes any impact on financial stability if the bank fails.

Today, because of Wall Street Reform, the financial system is in a more robust and resilient position than it was prior to the crisis. We have reduced overall leverage in the banking system. Banks have added over $500 billion of capital since the crisis to serve as a buffer for absorbing unexpected losses. The recently completed annual stress tests cover a wider swath of institutions, and illustrate that our largest banks have sufficient capital to withstand adverse shock scenarios and continue to lend to businesses.

In fact, despite suggestions by some that Wall Street Reform would impair our economic growth, the exact opposite has been true. While banks have adjusted to more prudent rules, they continue to increase lending to small businesses and families, helping to fuel the creation of 12 million jobs over 60 straight months of job growth—a record that our economy, with a safer financial system, continues to build on. This progress is both real and consequential.

The true test of reform should not be whether it prevents firms from taking risk or making mistakes, but whether it shapes a financial system strong and resilient enough to support long-term economic growth while remaining innovative and dynamic. In working toward this end, Treasury and the independent regulators continue to monitor carefully the effects of new reforms and to ensure that they are properly calibrated to the size, complexity, and risk profiles of individual institutions. Just as the business environment is constantly evolving, the regulatory community must be flexible enough to keep up with new challenges—including making adjustments where necessary and remaining vigilant to new emerging threats.

No law is perfect. But let me be clear: we will vigilantly defend Wall Street Reform against any change that increases risk within the financial system, weakens consumer, investor, or taxpayer protections, or impedes the ability of regulators to carry out their mission. Amid these discussions of technical fixes and tweaks to Wall Street Reform, we must not forget what we learned from the financial crisis: our financial firms are constantly evolving, and we must remain alert and responsive to new challenges in a dynamic system, toward the ultimate goal of maintaining the safety, soundness, and resiliency of our financial system.

We must also not forget who will pay a steep price if Congress rolls back critical safeguards, weakens oversight, and waters down appropriate rules of the road. It will be companies that play by the rules and serve their customers well. It will be small businesses who need access to credit to grow their businesses and create jobs. It will be working men and women trying to save for their children's education, a downpayment on a home, and their own retirement.

Promoting financial stability and protecting the American public from the next financial crisis should be an objective shared by the Administration, regulators, the financial sector, and Members of Congress, regardless of party. I look forward to working with this Committee, and with Congress as a whole, to continue to make progress in creating a more resilient and stable financial system.

PREPARED STATEMENT OF PAUL SCHOTT STEVENS

PRESIDENT AND CHIEF EXECUTIVE OFFICER, INVESTMENT COMPANY INSTITUTE

MARCH 25, 2015

Executive Summary

- Designation of systemically important nonbank financial companies is only one of several regulatory tools given the FSOC by the Dodd-Frank Act. Designation of a nonbank financial company as systemically important is intended to and should be used only as a last resort, when the FSOC has found, after thorough analysis based on all the criteria specified in the Act, that a firm poses significant, articulable risks to the stability of the financial system that cannot be remedied through other means.
- ICI supports U.S. and global efforts to address abuses and excessive risk in the financial system, but we are concerned that the FSOC is seeking to exercise its designation authority quite broadly and to the exclusion of other mandates. The opacity of the designation process only exacerbates this problem.
- The FSOC's recent informal changes to its designation process are welcome but fall well short. These changes should be codified in statute to provide greater certainty and predictability to the process. In addition, Congress must act to require the FSOC to give both primary regulators and companies under consideration for designation an opportunity to address identified systemic risks prior to designation. Such steps would support the FSOC's mission both by reducing risks in the financial system and by reserving SIFI designations and the exceptional remedies that flow therefrom only to those circumstances in which they are clearly necessary.
- In none of its nonbank designations thus far has the FSOC chosen to explain the basis for its decision with any particularity. Instead, it appears to have relied on a single metric (a firm's size) to the exclusion of the other factors cited in the Dodd-Frank Act. It also has theorized about risks instead of conducting the kind of thorough, objective, empirical analysis that should underlie its deci-

sions. The FSOC should be explicit about the systemic risks it identifies arising from a firm's structure or activities, and the results of any analysis that might lead to designation should be made public. This would be beneficial on all sides—it would help market regulators and firms address such risks, and it would promote public understanding of and confidence in what the FSOC regards to be systemically risky and why.

- We support the FSOC's review of the asset management sector as the Council fulfills its mandate under the Dodd-Frank Act. We are hopeful it will conclude, as we believe it must, that SIFI designation is unnecessary and inappropriate in the case of funds and their managers. The history of the recent financial crisis demonstrates that, compared to other parts of the financial system, U.S. stock and bond funds exhibited extraordinary stability. Unlike banks, fund managers act solely as agents. This means that fund investors—not fund managers—bear the risks and rewards of the fund. Funds use little or no leverage. Their structure, the way they are regulated and managed, and their overwhelmingly retail investor base—these and other factors all help explain why, in the 75-year history of the modern fund business, stock and bond funds have never posed risks to the financial system at large.
- We also support the role of the SEC as the regulatory body best equipped to address any concerns about financial stability with respect to funds and fund managers. While we believe there is no basis for designating them, recent proposals out of the FSB point to the prospect that the FSOC may soon consider designation for many large U.S. funds and their managers. If any of these entities was designated, the consequences would be highly adverse to investors and the capital markets. Application of the bank regulatory remedies set forth in the Dodd-Frank Act to designated stock and bond funds or their managers would raise costs on and jeopardize the interests of fund shareholders, greatly distort the fund marketplace, introduce a highly conflicted model of regulation, and compromise the important role that funds play as a source of financing in the economy.

I. Introduction

My name is Paul Schott Stevens. I am President and CEO of the Investment Company Institute (ICI or Institute), and I am pleased to appear before the Committee today to discuss the transparency and accountability of the Financial Stability Oversight Council (FSOC or Council) and particularly its processes for designating nonbank financial companies as systemically important financial institutions (SIFIs).

ICI is the national association of U.S. registered investment companies, including U.S. mutual funds, closed-end funds, exchange-traded funds (ETFs) and unit investment trusts. ICI seeks to encourage adherence to high ethical standards, promote public understanding and otherwise advance the interests of funds, their investors, directors and managers. ICI members today manage approximately $17.5 trillion in assets and serve more than 90 million investors. These investors rely on stock and bond funds to help achieve their most important financial goals, such as saving for college, purchasing a home, or providing for a secure retirement.

The Institute traces its origin back to 1940 and passage of the landmark Investment Company Act and Investment Advisers Act, statutes that the Securities and Exchange Commission (SEC) has administered to great effect and that have provided a comprehensive framework of regulation for our industry. ICI members are both investors in the capital markets and issuers of securities. We understand the important role of appropriate regulation in protecting our investors, promoting confidence in our markets, and ensuring the resiliency and vibrancy of the financial system overall. For these reasons, ICI has been an active supporter of U.S. and global efforts to address issues highlighted by the global financial crisis. We also have been a strong proponent of improving the U.S. Government's capability to monitor and mitigate risks across our Nation's financial markets.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act), by design, provides an array of tools, in addition to SIFI designation authority, to the FSOC and other regulators. For example, the FSOC has a risk monitoring role and has the authority to identify gaps in regulation and make recommendations to financial regulators.[1] The broad scope of these other authorities should allow the FSOC to reserve SIFI designation for those circumstances—

[1] 12 U.S.C. §5322(a)(2).

thought to be quite rare when the Dodd-Frank Act was enacted[2]—in which the risks to the financial system as a whole are both large and quite plain, and nothing less than designation will suffice to address them.

The record of the Council's activities to date, however, suggests that the FSOC may be ignoring this statutory construct and, instead, seeking to exercise its designation authority quite broadly. The highly opaque process of the FSOC leading to designation has only exacerbated the problem, raising serious concerns about whether its determinations have adequate factual bases, take public comment into sufficient account, and can be subject to appropriate oversight. Without engaging more meaningfully with the public and with entities under review, the FSOC has appeared to be in headlong pursuit of designations based on foreordained conclusions rather than on rigorous and objective empirical analysis.

To truly advance financial stability, the FSOC's process must be open to the public, analytically based and grounded in the historical record. The history of the recent crisis demonstrates that America's stock and bond funds exhibited extraordinary stability. In particular, it is important for the FSOC to consider carefully how different stock and bond funds and their managers are from banks. Unlike banks, fund managers act solely as agents, which means fund investors—not fund managers—bear the risk of any loss, or the benefit of any gain, in a portfolio. Moreover, registered funds use little to no leverage. The structure of these funds, the ways in which they are comprehensively regulated and managed, and their overwhelmingly retail investor base—these and other factors all help explain why, in the 75-year history of the modern fund industry, stock and bond funds have never experienced a "run" of the sort to which banks are subject.

As discussed below, we hope the FSOC's recently announced changes to its SIFI designation process will increase communications and interaction with firms that are under review. More, however, needs to be done. These recent procedural changes were instituted informally and should be codified in statute. In addition, Congress should amend the Dodd-Frank Act to ensure that an institution targeted for designation and that institution's primary regulator have the opportunity to address and mitigate any "systemic risks" the institution may pose prior to final SIFI designation. Bipartisan legislation introduced in the 113th Congress by Reps. Dennis Ross (R-FL) and John Delaney (D-MD), and four cosponsors, the "FSOC Improvement Act of 2014", would codify these and other good Government reforms to the SIFI designation process. Ultimately, this reasonable, bipartisan approach would enhance the ability of the FSOC to ameliorate systemic risk.

In addition, we believe it is imperative for Congress to revisit the remedies that follow upon SIFI designation in the asset management sector, and certainly so in the case of registered funds or their managers. The remedies currently provided for in the Dodd-Frank Act—i.e., imposition of bank-style capital requirements and prudential supervision by the Federal Reserve—not only are unnecessary but are altogether inappropriate in the case of registered funds and their managers. They would inflict substantial harm on fund investors and retirement savers, distort the fund marketplace, and impede the important role that funds play as a vital source of funding in our capital markets. As noted, we do not believe that funds or fund managers merit SIFI designation. But, if a fund or fund manager were deemed to be systemically important, Congress should look to the SEC, and not the Federal Reserve, to conduct appropriately enhanced oversight of its activities.

In Section II below, we outline our concerns about the FSOC's SIFI designation process, explain the limitations of the recent changes to the process that have been adopted by the FSOC, analytically why further action is necessary. In Section III, we explain why the lack of specifics in the FSOC's designations undermines the utility and fairness of the process. In Section IV, we set forth the basis for our concerns that the FSOC determinations be grounded in empirical data and historical experience, rather than the theory and conjecture as seems to be the Council's approach to stock and bond funds and their managers. In Section V, we discuss the ongoing FSOC process with regard to asset managers. Finally, in Section VI, we conclude with an explanation of the many worrisome consequences of inappropriately designating funds and asset managers, which would harm investors and financial markets.

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[2] See Testimony of Chairman Ben S. Bernanke, before the Committee on Financial Services, U.S. House of Representatives, July 24, 2009, available at *http://www.federalreserve.gov/newsevents/testimony/bernanke20090724a.htm* (stating that the "initial number of newly regulated firms [SIFIs] would probably be relatively limited").

II. The FSOC's SIFI Designation Process Should Be More Transparent and Accountable

The FSOC's SIFI designation process has been the subject of widespread criticism. Members of Congress from both parties have submitted numerous letters and statements expressing their own concerns. In 2014, for example, a bipartisan group of five Senators stated that one of the greatest problems with the SIFI designation process "is a lack of transparency and accountability."[3] The Government Accountability Office (GAO) likewise has urged the FSOC to make changes to its process, including "improv[ing] communications with the public."[4] Last year, several trade associations formally petitioned the FSOC to make changes to the SIFI designation process, including allowing entities undergoing review to receive more information and interact more extensively with the Council and its staff.[5]

In response to these repeated calls for change, the FSOC in November 2014 convened meetings with interested parties to discuss potential procedural reforms and thereafter, in February 2015, issued "supplemental procedures" to revise its SIFI designation process. The changes include, among other things, earlier notice to and opportunity to submit information by companies and their primary regulators under Stage 2 active review; meetings with the FSOC's Deputies Committee to allow companies in Stage 3 to present relevant information or arguments; a commitment to grant requests for oral hearings from companies in Stage 3; notices explaining a decision not to rescind a designation; and oral hearings for designated companies once every 5 years.[6]

ICI welcomes these changes, which were overdue, as an initial positive step towards providing greater fairness and clarity in the designation process. Nonetheless, more needs to be done to improve the FSOC's designation process. As it stands, the FSOC retain the absolute discretion to eliminate or change the new "supplemental procedures" at any time and without prior notice. Instead, the recent changes should be codified in law. This would provide a highly desirable predictability and certainty about FSOC's designation process.

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[3] See "Letter to The Honorable Jacob J. Lew, Secretary, U.S. Department of the Treasury, Chairman of the FSOC, from Sen. Mark Kirk (R-IL), Sen. Thomas Carper (D-DE), Sen. Patrick Toomey (R-PA), Sen. Claire McCaskill (D-MO), Sen. Jerry Moran (R-KS)", dated Jan. 23, 2014, (stating that "we strongly urge the FSOC and other governing bodies not to base any policy or regulation actions grounded on the information in the OFR study . . . . The OFR study mischaracterizes the asset management industry and the risks asset managers pose, makes speculative assertions with little or no empirical evidence, and, in some places, predicates claims on misused or faulty information"). Senator Mark Warner has also noted that SIFI designation analysis "should follow a rigorous and transparent process, using reliable data, so that regulators and the marketplace can be armed with the best information possible." "Letter to The Honorable Jacob J. Lew, Secretary, U.S. Department of the Treasury, Chairman of the FSOC, from Sen. Mark Warner (D-VA)", dated May 9, 2014. House Financial Services Chairman Jeb Hensarling also noted that, with the exception of the national security agencies dealing in classified information, the "FSOC may very well be the Nation's least transparent Federal entity." "Statement of Chairman Jeb Hensarling before House Financial Services Committee, Hearing on 'The Annual Report of the Financial Stability Oversight Council' (June 24, 2014). See also "Letter to The Honorable Jacob J. Lew, Secretary, U.S. Department of the Treasury, Chairman of the FSOC, from Rep. Carolyn B. Maloney (D-NY), Ranking Member, Subcommittee on Capital Markers and Government Sponsored Enterprises", dated July 29, 2014. In a letter to Federal regulators, Chairman Hensarling and others also commented that the "lack of transparency and due process injects needless uncertainty and instability into our financial markets." "Letter to The Honorable Jacob J. Lew, Secretary, U.S. Department of the Treasury, Chairman of the FSOC; The Honorable Janet Yellen, Chair, The Federal Reserve System; and The Honorable Mary Jo White, Chair, SEC, from Rep. Jeb Hensarling (R-TX), Chairman, House Financial Services Committee, and the respective Subcommittee Chairmen", dated May 9, 2014.

[4] See GAO, *New Council and Research Office Should Strengthen the Accountability and Transparency of Their Decisions* (Sept. 2012), available at *http://www.gao.gov/assets/650/648064.pdf;* GAO, *Continued Actions Needed To Strengthen New Council and Research Office* (Mar. 14, 2013), available at *http://www.gao.gov/products/GAO-13-467T;* GAO, *Further Actions Could Improve the Nonbank Designation Process* (Nov. 2014), available at *http://www.gao.gov/assets/670/667096pdf.*

[5] The American Council of Life Insurers, the American Financial Services Association, the Association of Institutional Investors, the Financial Services Roundtable, and the Asset Management Group of the Securities Industry and Financial Markets Association, "Petition for FSOC Rulemaking Regarding the Authority To Require Supervision and Regulation of Certain Nonbank Financial Companies", (Aug. 19, 2014), available at *http://fsroundtable.org/rulemaking-petition-fsoc/.*

[6] FSOC, "Supplemental Procedures Relating to Nonbank Financial Company Determinations" (Feb. 4, 2015), available at *http://www.treasury.gov/initiatives/fsoc/designations/Documents/Supplemental-Procedures-Related-to-Nonbank-Financial-Company-Determinations-February-2015.pdf.*

In addition, we believe Congress must act to reform the FSOC's designation process[7] in ways that will advance the Dodd-Frank Act's dual goals of reducing systemic risk while reserving SIFI designation as a tool to be used only in truly exceptional cases:

- First, the FSOC should allow a targeted firm's primary financial regulator an opportunity, prior to designation, to address any systemic risks identified by the FSOC. A company's primary regulator generally will have greater expertise and regulatory flexibility than the FSOC to address identified risks. By way of example, the SEC already has the necessary authority—and is taking steps—to strengthen oversight of asset managers and funds, including by expanding oversight of risk management in key areas and enhancing its collection of mutual fund data.[8]
- Second, an entity being reviewed for SIFI designation should have an opportunity to make changes to its structure or business practices to address identified systemic risks prior to designation. Allowing a firm the opportunity to change its business model or practices often may be the most effective way to address the identified risks.

These reforms would further the objectives of promoting market discipline and reducing systemic risk, all while reserving designation for the exceptional circumstances for which it was intended. It also would avoid undue imposition of the remedies outlined in the Dodd-Frank Act on nonbank institutions for which they are clearly inappropriate. As specified in the Act, those remedies include the following: a risk based capital requirement potentially as high as 8 percent;[9] "enhanced prudential supervision" by the Federal Reserve;[10] and susceptibility to paying into a resolution fund in the event of the failure of a bank SIFI.[11] We discuss the consequences of these statutory remedies for funds and their managers in Section VI below.

Ill. The Absence of Particularity in SIFI Determinations Impedes Interested Parties From Understanding and Benefiting From the FSOC's Analyses

Providing a company and its primary financial regulator an opportunity to mitigate identified systemic risks prior to designation would have the added benefit of requiring the FSOC to explain the bases for its designation decisions with some particularity. As discussed below, this is not something the FSOC has done in any of its nonbank SIFI designations thus far. Requiring an appropriate degree of specificity would enable the firm under consideration, the firm's principal regulator, other market participants, Congress and the public at large to understand the specific reasons for the FSOC's actions, thus enhancing both the transparency and accountability of the Council and its actions.

The Dodd-Frank Act permits the FSOC to designate a nonbank financial institution as "systemically important" in one of two situations. The FSOC may designate a firm if either (1) the company's material financial distress (the First Determination Standard) or (2) the nature, scope, size, scale, concentration, interconnectedness, or mix of the company's activities (the Second Determination Standard), could pose a threat to the financial stability of the United States.[12] To date, the FSOC has predicated all of its nonbank SIFI determinations on the basis of the First Determination Standard and has not addressed whether the activities of the company

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[7] As noted, bipartisan legislation introduced in the 113th Congress by Reps. Dennis Ross (R-FL) and John Delaney (D-MD), and four cosponsors, H.R. 5180, the FSOC Improvement Act, would codify these and other good Government reforms to the SlFI designation process. Additional provisions in the hill include important annual and 5-year reviews of prior SIFI designations in order to provide important information to firms and to the public about as to how previously designated SIFIs can take measures to ameliorate risks.

[8] "Remarks at the *New York Times* DealBook Opportunities for Tomorrow Conference", Mary Jo White, Chair, SEC (Dec. 11, 2014), available at *http://www.sec.gov/News/Speech/Detail/Speech/1370543677722#.VJMKZ14AKB.*

[9] 12 U.S.C. §5371. An unresolved inconsistency between two provisions in the Dodd-Frank Act calls into serious question just how much flexibility the Federal Reserve would have to limit the application of capital requirements to any U.S. mutual fund designated as a SlFI or G–SIFI. Although one provision of the Dodd-Frank Act gives the Federal Reserve discretion in applying capital standards to nonbank SIFIs (Section 165(b)(1)(A)(i) of the Dodd-Frank Act (providing the Federal Reserve authority to determine that capital standards are inappropriate for a particular SIFI and to substitute "other similarly stringent risk controls.")), another provision—known as the "Collins Amendment"—may not (see Section 171 of the Dodd-Frank Act, which requires the imposition of minimum-leverage capital and risk-based capital standards on any SIFI).

[10] 12 U.S.C. §5365.

[11] 12 U.S.C. §539(o)(1)(D)(ii)(l).

[12] 12 U.S.C. §5323(a)(1).

could pose a threat to the financial stability of the United States. In its 2014 report on improving the FSOC designation process, the GAO noted the FSOC's exclusive reliance on the First Determination Standard, and expressed concern that the approach was flawed and would lead the FSOC to ignore certain risks. [13]

In effect, the approach taken by the FSOC has led to designations that appear to be based on a firm's size, rather than on the basis of the more complete and detailed analysis of a firm's activities and the risks they present, as the Dodd-Frank Act envisioned. [14] The FSOC's State insurance commissioner representative stated, in response to the MetLife, Inc. (MetLife) designation, that "the [FSOC] has failed to address the criticism that it did not conduct a robust analysis of characteristics of MetLife beyond its size," and that without more specific details on the bases for determination, "any large company could meet the statutory standard applied by the [FSOC]." [15] In fact, Congress expressly required in the Dodd-Frank Act that the FSOC consider at least 10 statutory factors, only 2 of which directly relate to an institution's size. [16] By avoiding any discussion of the particular aspects or activities of an institution that are thought to pose systemic risks, the FSOC not only forecloses the prospect of any meaningful, reasoned justification for its decisions, but also frustrates congressional intent.

In addition, and equally troubling, the FSOC's exclusive reliance on the First Determination Standard does nothing to inform a designated nonbank firm, other market participants, Congress or the general public about the primary drivers (if any, other than size) of the Council's designation decision. It therefore offers the firm no insight into how it might "de-risk" and thereby no longer merit SIFI designation or require application of the exceptional remedies specified in the Dodd-Frank Act. This is an odd result indeed if the object of the exercise is to eliminate or minimize what are thought to be outsized risks to the financial system at large.

The GAO's 2014 study makes a similar point. The GAO found that even nonpublic documentation of Stage 3 evaluations—the final stage of the FSOC's multistaged analytic process—did not include sufficient detail on the bases for the FSOC's determinations. [17] In dissenting from MetLife's SIFI designation, S. Roy Woodall, the presidentially appointed independent member of the FSOC with insurance expertise, noted that basing determinations solely on the First Designation Standard "does little else to promote real financial system reform" because it does not provide "constructive guidance for the primary financial regulatory authorities, the [Federal Reserve] Board of Governors, international supervisors, other insurance market participants and, of course, MetLife itself, to address any [systemic] threats posed by the company." [18]

The FSOC should be explicit about the systemic risks it identifies arising from a firm's structure or activities. It should provide enough detail to enable both a company and its primary regulator to respond substantively with proposals to mitigate the risk. This is beneficial on all sides—systemic risk would be curbed, the public and market might gain insight on what activities or structures the FSOC considers to be systemically risky and why, and the firm could avoid unnecessary and potentially inappropriate regulation and supervision.

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[13] See GAO, "Further Actions Could Improve the Nonbank Designation Process" (Nov. 2014), available at *http://www.gao.gov/assets/670/667096.pdf*.

[14] The Financial Stability Board (FSB) has proposed to take a similarly flawed approach, focusing in its second consultation on the size of firms to the exclusion of other factors. See FSB, "Second Consultative Document: Assessment Methodologies for Identifying Nonbank Non-Insurer Global Systemically Important Financial Institutions" (Mar. 4, 2015), available at *http://www.financialstabilityboard.org/wp-content/uploads/2nd-Con-Doc-on-NBNI-G-SIFI-methodologies.pdf*.

[15] Adam Hamm, "View of the State Insurance Commissioner Representative" (Dec. 2014), available at *http://www.treasury.gov/initiatives/fsoc/designations/Documents/Dissenting%20and%20Minority%20Views.pdf*.

[16] See 12 U.S.C. §5323(a)(2). The two considerations are 12 U.S.C. §§5323(a)(2)(I) and (J), which require the FSOC to consider "the amount and nature of the financial assets of the company" and "the amount and types of the liabilities of the company, including the degree of reliance on short-term funding," respectively.

[17] See GAO, "Further Actions Could Improve the Nonbank Designation Process", at 35 (Nov. 2014), available at *http://www.gao.gov/assets/670/667096.pdf* (stating that the FSOC's nonpublic documentation "could have benefited from inclusion of additional detail about some aspects of its designation decisions").

[18] S. Roy Woodall, "Views of the Council's Independent Member Having Insurance Expertise" (Dec. 2014), available at *http://www.treasury.gov/initiatives/fsoc/designations/Documents/Dissenting%20and%20Minority%20Views.pdf*.

IV. The FSOC's Approach to Designation Is Predicated on Conjecture, as Opposed to Empirical Data

If the FSOC were required to provide greater specificity about the bases for its designation decisions, as the Dodd-Frank Act anticipates, it would be more likely to engage in the kind of robust, empirically based, data-driven, "bottom up" analysis that one would reasonably expect in connection with such a significant regulatory determination. Such an approach would take fully into account all of the factors that Congress enumerated in Section 113 of the Dodd-Frank Act, including the degree to which a firm already is regulated and the prospects of using that preexisting regulatory structure to address perceived risks. It would help ensure that designations are not made on the basis of prejudgment or conjecture or on "implausible, contrived scenarios"; it also would make the FSOC far less susceptible to criticism, from within its own ranks, for "failures to appreciate fundamental aspects" of a potential designee's business, products, and services.[19] Remarkably, in dissenting to Prudential Financial, Inc.'s (Prudential) designation as a SIFI, Mr. Woodall observed the following:

> Key aspects of [the FSOC's] analysis are not supported by the record or actual experience; and, therefore, are not persuasive. The underlying analysis utilizes scenarios that are antithetical to a fundamental and seasoned understanding of the business of insurance, the insurance regulatory environment, and the State insurance company resolution and guaranty fund systems . . . . [T]he grounds for the Final Determination are simply not reasonable or defensible, and provide no basis for me to concur.[20]

The State insurance representative on the FSOC, John Huff, agreed; he found the FSOC's analysis of Prudential to be "flawed, insufficient, and unsupportable."[21]

Moreover, this highly theoretical approach is not unique to the FSOC. The Financial Stability Board (FSB) recently issued a second consultation on evaluation criteria for nonbank, noninsurer global SIFIs (NBNI G–SIFIs).[22] In this second consultation, the FSB frankly states that "the NBNI G–SIFI assessment methodologies aim to measure the impact that an NBNI financial entity's failure can have on the global financial system and the wider economy, rather than the *probability* that a failure could occur."[23] Apparently, if bank regulators meeting in Switzerland can conjure up some "systemic" concern, then their conjecture can serve as a basis for global policymaking—even if it has no historical, factual or even rational predicate. When we have argued for a process informed by facts, we often have been invited to prove a negative—that is, to demonstrate that the hypothetical risks so articulated cannot arise.

In sum, the way in which the FSOC has approached the question of nonbank SIFI designation has every feel of a result-oriented exercise as opposed to an objective analysis—where a single blunt metric (size) dwarfs the other statutory factors and mere hypotheses are used to compel a seemingly predetermined outcome—i.e., that designation is required.

We believe Congress expected, and it should demand, something more of the FSOC. SIFI designation should be predicated on a thorough, objective analysis of a specific institution, its structure and activities, its historical experience, the ways in which it is regulated currently and ocher empirical information, including all the factors set out in the Dodd-Frank Act—and the results of this analysis should be made available to the public. Relatedly, if it determines to consider asset managers and their funds for SIFI designation, the FSOC should subject the metrics and thresholds used to evaluate such entities to notice and comment.[24] With such a

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[19] Id.

[20] S. Roy Woodall, "Views of the Council's Independent Member Having Insurance Expertise" (Sept. 19, 2013), available at *www.treasury.gov/initiatives/fsoc/councilmeetings/Documents/September%2019%202013%20Notational%20Vote.pdf.*

[21] John Huff, "View of Director John Huff, the State Insurance Commissioner Representative" (Sep. 2013), available at *http://www.treasury.gov/initiatives/fsoc/council-meetings/Documents/September%2019%202013%20Notational%20Vote.pdf.*

[22] FSB, supra note 14.

[23] Id. at 10, emphasis in the original.

[24] The FSOC has warned that it may use other methods to assess the asset management industry, but, as a bipartisan group of Congressmen has pointed out, "the FSOC: should . . . publicly disclose the economic models, data, and analysis that support its approach before taking any steps to identify particular asset management entities for SIFI designation." Letter to The Honorable Jacob J. Lew, Secretary, U.S. Department of the Treasury, Chairman of the FSOC, from Reps. Dennis Ross (R-FL) and John Delaney (DMD) and 39 other members of the House Financial Services Committee (May 9, 2014). Publicizing the metrics will ensure the FSOC is

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focus on facts, the FSOC also would do well to consider whether using one of the other tools that the Dodd-Frank Act makes available to it would be more appropriate than SIFI designation. Indeed, requiring a consideration of the costs and benefits of designation would put the FSOC's decision making on par with the Administrative Procedure Ace's requirements for significant rulemakings and the Obama administration's executive orders regarding rulemaking processes. [25]

V. The FSOC's Review of Asset Management Appears Similarly Flawed

A 2013 report on asset management written by the Office of Financial Research (OFR), the research arm of the FSOC, heightened our concerns with the FSOC's SIFI review process and demonstrated the need for increased public input. The report was the subject of withering criticism—for reflecting a deeply inaccurate understanding of the asset management industry, for rendering sweeping conclusions unsupported by data or analysis and for lacking clarity, precision, and consistency in its scope, focus, and use of data. [26]

Regrettably, the FSOC appears to be persisting in this pattern of reliance on conjecture and hypothesis in its consideration of liquidity and redemption risks associated with investment vehicles that are offered by asset managers. Its recent Notice Seeking Comment on Asset Management Products and Activities (the Notice) [27] simply assumes a variety of potential threats to the financial system arising from asset management, much as the OFR report did in 2013. For example, the Notice hypothesizes that shared trading costs for stock and bond funds create a unique and powerful incentive for fund investors to redeem en masse in the face of a market decline, potentially leading to severe additional downward pressure on markets. The Notice points to no historical experience nor any empirical data to support this hypothesis. In fact, there is none: the hypothesis is based on a series of assumptions that simply do not reflect how stock and bond funds and their managers operate nor how their investors behave, as the Institute discusses in detail in its comment letter to the FSOC to be filed on March 25, 2015. Even if this hypothesis were at all plausible, there is nothing to suggest it would in fact pose a risk to financial stability.

While we are concerned with the highly theoretical nature of some of the questions presented in the Notice, ICI commends the FSOC for seeking public comment on this occasion. We hope and expect that Council members will thoroughly review and give due consideration to all the public comments they receive, including the extensive research and commentary submitted by ICI and its members. A transparent, fact-based and fair FSOC process with respect to funds and their managers—one that takes full account of the structure and characteristics of these entities, the ways in which they operate, the 75-year history of the industry, and the highly effective framework of regulation under which it currently operates—will, we believe, allay any concerns that funds or their managers pose risks to the financial system meriting SIFI designation.

VI. The Consequences of Inappropriate Designations Would Be Severe

Ensuring that the FSOC meets high standards of transparency and accountability as it exercises its authority under the Dodd-Frank Act is vitally important: its des-

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not relying on inaccurate data and false assumptions, such as those in the Office of Financial Research's Asset Management Study.

[25] Exec. Order No. 13,563, 76 *Fed. Reg.* 3821 (Jan. 21, 2011) (requiring certain agencies to engage in cost-benefit analysis before rulemaking); Exec. Order 13,579, 76 *Fed. Reg.* 41585 (July 14, 2011) (encouraging independent regulatory agencies to engage in cost-benefit analysis before rulemaking).

[26] See, e.g., "Letter to the Honorable J. Lew, Secretary, U.S. Department of the Treasury, Chairman of the FSOC, from Sen. Mark Kirk (R-IL), Sen. Thomas Carper (D-DE), Sen. Patrick Toomey (R-PA), Sen. Claire McCaskill (D-MO), Sen. Jerry Moran (R-KS)", dated Jan. 23, 2014, (stating that the report "mischaracterizes the asset management industry and the risks asset managers pose, makes speculative assertions with little or no empirical evidence, and in some places, predicates claims on misused or faulty information"); "Letter to The Honorable Jacob J. Lew, Secretary, U.S. Department of the Treasury, Chairman of the FSOC, from Sen. Mike Crapo (R-lD)", dated Jan. 27, 2014 (stating that "OFR's failures to take into account the perspectives of and data from market participants will result in flawed evaluation of the asset management industry by FSOC and, worse, a move towards designation of asset management firms as SIFIs without an accurate understanding of the rule they play in the financial system"); Daniel M. Gallagher, Commissioner, SEC, "Public Feedback on OFR Study on Asset Management Issues" (May 14, 2014), available at *http://www.sec.gov/comments/am-1/am1-52.pdf.* (citing multiple critics of the asset management report and calling the report "a botched analysis that grossly overstates—indeed, in many cases simply invents without supporting data—the potential risks to the stability of our financial markets posed by asset management firms").

[27] 80 *Fed. Reg.* 7595 (Feb. 5, 2015), available at *http://www.gpo.gov/fdsys/pkg/FR-2015-02-11/pdf/2015-02813.pdf.*

ignations carry with them exceptional consequences. In the case of funds and their managers, we submit that there is no basis for designation—and, if they were designated, the consequences would be highly adverse to investors and the capital markets.

As noted above, if a fund or its manager were to be designated a SIFI, the Dodd-Frank Act could require it to meet bank-level capital requirements. The fund or manager would have to cover the costs of its "enhanced prudential supervision" by the Federal Reserve. It would bear a share of the costs of the FSOC and OFR annually. It would even be subject to assessments to cover the cost of bailing out another SIFI if one were to fail, thus exposing fund investors (likely retirement savers) to having to foot the bill.

All of these costs would be unique to the designated fund or manager, and thus uniquely borne by that fund complex. The fund marketplace in the U.S. is highly competitive. There are many substitutable funds and providers from which to choose, and our investors and their financial advisers are properly focused on the impact of fees and expenses on long-term investment results. It is not apparent that a stock and bond fund or manager saddled with the additional costs of being a SIFI can remain fully competitive under these circumstances. Its shareholders may have very strong incentives to invest elsewhere. SIFI designation for some funds or fund managers thus stands to greatly distort the fund marketplace.

Of still more fundamental concern are the implications of "enhanced prudential supervision" of a stock or bond fund or its manager by the Federal Reserve. The bank model of regulation seeks first and foremost to preserve the safety and soundness of banks and the banking system. It contrasts strongly with the model of regulation enshrined in the Investment Company Act and Investment Advisers Act as administered by the SEC. Under that model, the adviser to a fund owes the fund's shareholders an exclusive duty of loyalty and care—and one of the SEC's primary missions is to protect the fund investors' interests.

An overlay of bank regulation thus would introduce a new and troubling dynamic of conflicted regulation. For example, a SIFI-designated stock and bond fund or its manager would be expected to comply with the Federal Reserve's directions about how to manage its investment portfolio, irrespective of the fund adviser's or independent directors' fiduciary duties or the best interests of the fund's shareholders. This is not a theoretical concern. In the aftermath of the financial crisis, some bank regulators vocally criticized fund managers for acting to protect their investors from financial losses by not maintaining short-term investments with banking institutions that were at risk of failure.[28] The priority of the bank regulators, of course, was not protecting the interests of the fund investors, but propping up failing banks and thereby the banking system.

Just this kind of approach to regulating asset managers is something that Federal Reserve Governor Daniel K. Tarullo explicitly called for in a recent speech—terming it "prudential market regulation," something needed to provide a "systemwide perspective" that would trump traditional investor protections and market regulation and respond to "systemwide demands."[29] Presumably, any fund or manager designated a SIFI henceforward would be put to the service of two masters—the Federal Reserve in the interests of the "system," and secondarily the fund's shareholders.

Moreover, a SIFI regime for funds or their managers likely will result in highly prescriptive regulations and a common sec of "approved" investments within portfolio structures—just as the Basel standards pushed banks toward a standard portfolio of "lower-risk" assets, and thus helped usher in the financial crisis of 2008. This is the model that the Federal Reserve would bring to asset management. With it would come decreasing diversification, increasing correlation, great volatility, and more—not less—risk. Such requirements would ultimately compromise and diminish the exceptional role that funds play as a source of financing to the economy.

That the remedies in the Dodd-Frank Act seem altogether inappropriate when applied to stock and bond funds and their managers is perhaps not surprising: during

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[28] "Remarks at the Federal Reserve Bank of New York Workshop on Fire Sales as a Driver of Systemic Risk in Triparty Repo and Other Secured Funding Markets", Jeremy C. Stein, Member, Board of Governors of the Federal Reserve System (Oct. 4, 2013), available at *http://www.federalreserve.gov/newsevents/speech/stein20131004a.htm;* "Remarks at the Global Research Forum on International Macroeconomics and Finance on Dollar Funding and Global Banks", Jeremy C. Stein, Member, Board of Governors of the Federal Reserve System (Dec. 17, 2012), available at *http://www.bis.org/review/r121218c.pdf.*

[29] "Remarks at the Office of Financial Research and Financial Stability Oversight Council's 4th Annual Conference on Evaluating Macroprudential Tools: Complementarities and Conflicts", Daniel K. Tarullo, Member of the Federal Reserve System (Jan. 30, 2015), available at *http://www.federalreserve.gov/newsevents/speech/tarullo20150130a.pdf.*

consideration of the Dodd-Frank Act, there was no thought that these remedies would be applied to a part of the financial system that had remained comparatively so resilient even in the midst of the crisis.

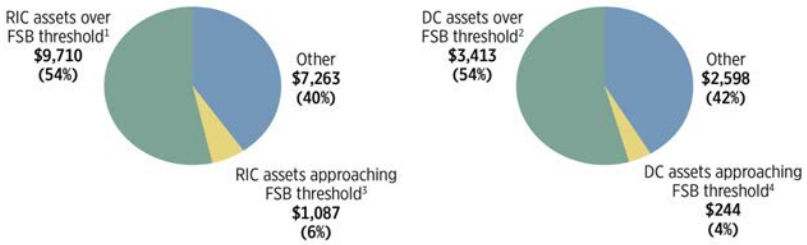
This underscores the need for Congress to craft, with respect to asset management, a very different set of remedies that would flow from any SIFI designation. If the FSOC does identify systemic risks in the asset management sector, we believe enhanced oversight by the SEC, and not by the Federal Reserve, is appropriate.

The figure [below] illustrates just how consequential allowing the FSOC and the Federal Reserve to proceed down the current path is likely to be. In connection with its "Workstream on Other Shadow Banking Entities",[30] led personally by Governor Tarullo, the FSB recently released for public comment proposed thresholds for identifying the pool of asset managers and individual funds that automatically would be evaluated for potential designation as G–SIFIs. The FSB proposes alternative thresholds for funds and for asset managers. The below chart applies the broader FSB threshold for funds—any fund with assets of more than $100 billion in assets. For asset managers the below chart applies the FSB's $1 trillion under management threshold.

The vast majority of the funds and asset managers that automatically would be evaluated under these criteria are U.S. firms. Applying these thresholds to our industry—something that seems to be highly likely if the FSB adopts them[31]—we estimate that more than half of the $6.3 trillion in assets in defined contribution plans would fall either directly or indirectly under the "enhanced prudential supervision" and thus the "prudential market regulation" of the Federal Reserve, assuming that the funds and managers meeting the thresholds are designated. More broadly, we estimate that well over half—nearly $10 trillion—of the $18 trillion in assets that U.S. households have invested in mutual funds, ETFs, or other registered investment companies would fall under such supervision by the Federal Reserve.

Under FSB Proposal, Federal Reserve Would Be "Prudential Market Regulator" for More Than Half of U.S. Regulated Fund and Defined Contribution (DC) Plan Market

Billions of dollars



[1] Represents registered investment company (RIC) assets managed by asset managers with over $1 trillion in AUM globally or RIC assets managed by asset managers with at least one regulated fund whose net assets exceed $100 billion.

[2] Represents defined contribution (DC) assets managed by asset managers with over $1 trillion in AUM globally or DC assets managed by asset managers with at least one regulated fund whose net assets exceed $100 billion.

[3] Represents registered investment company (RIC) assets managed by asset managers with over $750 billion in AUM globally.

[4] Represents DC assets managed by asset managers with over $750 billion in AUM globally.

Note: Components may not add to the total because of rounding.

Sources: Investment Company Institute and Pensions and Investments

We do not believe that any Member of Congress had any conceivable notion of the prospect that this extraordinary expansion of Federal Reserve authority could result from the Dodd-Frank Act. Surely, however, important participants today in the FSOC and FSB are well aware of it. And, ironically, there are voices in the bank

[30] FSB, supra note 14.

[31] We note that all insurance companies that have been designated as SIFIs were first designed by the FSB as global systemically important insurers (G–SIIs).

regulatory community urging that the real problem with the FSOC is not that it has too little accountability, but that it has too much—and give due consideration to all these extraordinary new regulatory powers with a very high degree of independence from Congress and the executive branch.[32]

In conclusion, let me say that ICI and all its members have deep concerns about the transparency, accountability, and fairness of the FSOC process. We by no means object to the Council's examination of asset management as it weighs possible outsized risks to the financial system. What we do ask is simple, and nothing more than common sense and good governance would seem to require:

- The FSOC should consider all the tools available to it to mitigate risks, not simply SIFI designation;
- SIFI designations should have a clear and compelling empirical basis and take into account all the factors Congress enumerated in statute;
- The FSOC should communicate with particularity the bases for its designations;
- Congress should ensure that there is an opportunity for "de-risking" by a primary regulator and by the institution concerned in advance official SIFI designation; and
- In the event that the FSOC does not heed the volume of data to the contrary and designates a stock or bond fund or asset manager as a SIFI, Congress should ensure that the remedies to which the designated fund or manager is subject are appropriate ones, for those currently contained in the Dodd-Frank Act clearly are not.

We appreciate the opportunity to share these views with the Committee. ICI looks forward to working with Congress on reforming the FSOC's SIFI designation process to ensure that it works as Congress intended.

PREPARED STATEMENT OF DOUGLAS HOLTZ-EAKIN

PRESIDENT, AMERICAN ACTION FORUM

MARCH 25, 2015

Chairman Shelby, Ranking Member Brown, and Members of the Committee, thank you for the opportunity to appear today and share my views on the Financial Stability Oversight Council (FSOC or the Council) nonbank designation process.* FSOC's mission is to identify, monitor, and address threats to America's financial stability. Yet without significant changes to the process by which nonbank financial companies (NBFCs) are designated as systemically important and regulated, FSOC risks losing the confidence of the public and policymakers and burdening the economy without resultant benefits. In my testimony, I wish to make three main points:

- FSOC's process thus far has prioritized designation and regulation of institutions over the identification of activities that pose systemic threats, and done so in a fundamentally flawed manner. I applaud the Committee for taking a critical look at this process and all its implications;
- Further clarity is needed on the metrics leading to designation. And equally important, companies must be able to address the activities identified as posing systemic risk, avoid a designation, and, if unable to do the aforementioned, have a path exiting designation;
- Finally, recently adopted procedures to open up FSOC and improve communication with firms under review should be commended as a good first step.

Let me provide additional detail on each in turn.

Current Nonbank Designation Process

Title I, Subtitle A, of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) established FSOC, outlined the Council's powers, and introduced factors that must be considered when designating NBFCs as systemically important financial institutions (SIFIs). Because banking companies with over $50

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[32] See, e.g., Donald Kohn, "Institutions for Macroprudential Regulation: The U.K. and the U.S." (Apr. 17, 2014), available at *http://www.brookings.edu/research/speeches/2014/04/17-institutions-macroprudential-regulation-kohn* (advocating for a change in the FSOC's structure "to enhance its independence").

*I thank Marisol Garibay, Sarah Hale, and Andy Winkler for their assistance. The views expressed here are my own and not those of the American Action Forum.

billion in assets are automatically considered SIFIs in the Dodd-Frank Act, key issues involving designation revolve around nonbanks.

Specifically, Section 113 of the Dodd-Frank Act gives FSOC the authority by two-thirds vote (including the chairperson) to bring a NBFC under increased supervision and regulation by the Federal Reserve Board (FRB) if the Council determines that "material financial distress at the U.S. nonbank financial company, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the U.S. nonbank financial company, could pose a threat to the financial stability of the United States."[1] In making that determination, the Dodd-Frank Act lists 10 criteria for FSOC to consider along with "any other risk-related factors that the Council deems appropriate."[2] As such, FSOC has broad authority statutorily when evaluating companies for SIFI designation. In April 2012, FSOC released a final rule and interpretive guidance on the process it uses to designate SIFIs.[3] The Council recently voted to supplement that process during its February 2015 meeting following an internal review and input from the public and stakeholders.[4]

The three-stage evaluation process FSOC developed is intended to narrow the pool of companies potentially subject to designation by applying specific thresholds based on 11 criteria included in Section 113 of the Dodd-Frank Act. The 11 criteria have been incorporated into six overarching framework categories that FSOC considers: (1) size, (2) interconnectedness, (3) leverage, (4) substitutability, (5) liquidity risk and maturity mismatch, and (6) existing regulatory scrutiny. Table 1 highlights how thresholds in these categories are applied and how scrutiny increases as a company advances through each stage. However, in practice, it is not clear the weight given to certain factors over others or what makes a designation more likely.

TABLE 1. FSOC DESIGNATION PROCESS

STAGE 1: APPLY QUANTITATIVE THRESHOLDS

A NBFC moves on to Stage 2 if it has:

(1) $50 billion in total consolidated assets, and

(2) One of the following:

- $30 billion in gross notational credit default swaps outstanding for which a NBFC is the reference entity;
- $3.5 billion of derivative liabilities;
- $20 billion in total debt outstanding;
- 15 to 1 leverage ratio of total consolidated assets (excluding separate accounts) to total equity; or
- 10 percent short-term debt ratio of total debt outstanding with a maturity of less than 12 months of total consolidated assets (excluding separate accounts).

Note: FSOC reserves the right to "evaluate any NBFC based on other firm-specific qualitative or quantitative factors, irrespective of whether such company meets the thresholds."[5]

STAGE 2: QUANTITATIVE & QUALITATIVE ANALYSIS

In further detail, FSOC applies its six-category framework:

- Size
- Leverage
- Interconnectedness
- Liquidity Risk & Maturity Mismatch
- Substitutability
- Existing Regulatory Scrutiny

The Council evaluates the risk profile and characteristics of each NBFC using industry- and company-specific factors, with company information being gathered from existing regulators and public sources as well as information submitted voluntarily by companies under consideration.

STAGE 3: IN-DEPTH ANALYSIS OF COMPANY

With previously amassed information, FSOC performs an in-depth analysis of the company based on the six-category framework. Through OFR, FSOC further collects confidential data obtained from the firm to incorporate in its analysis.

[1] 12 U.S.C. §5323 (a)(1).

[2] 12 U.S.C. §5323 (a)(2)(K).

[3] "Authority To Require Supervision and Regulation of Certain Nonbank Financial Companies; Final Rule and Interpretive Guidance", 77 *Federal Register* 70 (April 11, 2012) pp. 21637–21662; *https://federalregister.gov/a/2012-8627.*

[4] FSOC, "Supplemental Procedures Relating to Nonbank Financial Company Determinations", (February 4, 2015); *http://www.treasury.gov/initiatives/fsoc/designations/Documents/Supplemental__Procedures__Related__to__Nonbank__Financial__Company__Determinations-February__2015.pdf.*

Table 2 includes a summary of all changes adopted in February, many of which attempt to address the need for increased transparency and communication. Items shaded in gray are substantially similar to reforms previously highlighted in past work by the American Action Forum.[5] [6] [7] [8]

TABLE 2. SUMMARY OF FSOC'S SUPPLEMENTAL PROCEDURES ADOPTED IN FEBRUARY 2015
CATEGORY 1: ENGAGEMENT WITH COMPANIES UNDER CONSIDERATION BY FSOC (IN STAGES 2 & 3)
• Company to be notified in Stage 2 when it comes under active review
• Company in Stage 2 has the opportunity to submit relevant information to the Council and meet with FSOC staff
• When requested, FSOC staff should provide a company under consideration with a list of the public sources of information from which FSOC derives its decision
• Company notified in writing if it is not advanced to Stage 3 (though FSOC reserves the reconsider the company again in the future)
• Staff would meet with a companies' representatives at the start of Stage 3 to explain the evaluation process, framework for analysis, and specific activities and operations viewed by FSOC staff as the primary focus of their Stage 2 evaluation
• FSOC will explain the purpose of requested information in Stage 3 in relation to the risks being analyzed
• Companies can continue to submit material they deem relevant and request meetings with FSOC staff during Stage 3
• FSOC intends to grant hearing requests from companies subject to a proposed designation
• FSOC will engage with a company's primary financial regulatory, including notifying the regulator when a company comes under active review in Stage 2 and beginning the consultation process before any vote to advance a company to Stage 3
CATEGORY 2: THE ANNUAL REEVALUATION OF DESIGNATED COMPANIES
• Designated company is given the opportunity to meet with FSOC staff prior to annual reevaluation of its designation, discuss scope and process of review, and present them with any relevant information that could change the need for a systemically important determination
• FSOC will issue an explanation of its decision (addressing the company's objections) to maintain a systemically important designation if a company contests following its annual reevaluation, and inform the company, its primary regulator, and the primary regulator of its significant subsidiaries
• FSOC will provide a company subject to determination the opportunity for an oral hearing once every five years to contest its designation
CATEGORY 3: TRANSPARENCY TO THE BROADER PUBLIC REGARDING THE DESIGNATION PROCESS
• If a company publicly announces it is in active review in Stage 2 or 3, FSOC will confirm it upon request
• FSOC will include more public information on the bases of its designations
• FSOC will publish more information during its annual report including the number of nonbanks FSOC voted to move or not move on to Stage 3, became subject to a proposed or final determination, and the aggregate number of companies subject to a final determination
• FSOC will publish further detail on how the Stage 1 thresholds are calculated

Because Dodd-Frank gives FSOC such expansive authority to set the specific determinants of a SIFI designation, FSOC's operational procedures have largely been set internally and through the regulatory rulemaking process. Table 3 outlines the actions FSOC and the Federal Reserve Board have taken to date to define their procedures, receive feedback from the public, and exercise their authority to designate NBFCs and regulate them. Since its creation, four NBFCs (AIG, GE Capital, Prudential Financial, and MetLife) have already been affirmatively voted as SIFIs. FSOC voted unanimously to designate AIG and GE Capital in June 2013 and reaffirmed their status last year. The votes to designate Prudential Financial and MetLife, in September 2013 and December 2014, respectively, were not unanimous—both included objections from the voting and nonvoting members of FSOC with insurance experience.

[5] "Authority To Require Supervision and Regulation of Certain Nonbank Financial Companies; Final Rule and Interpretative Guidance", 77 *Federal Register* 70 (April 11, 2012) p. 21661; *https://federalregister.gov/a/2012-8627.*

[6] Satya Thallam, "Considering an Activity-Based Regulatory Approach to FSOC", (September 12, 2014) *http://americanactionforum.org/research/considering-an-activity-based-regulatory-approach-to-fsoc.*

[7] Satya Thallam, "Reform Principles for FSOC Designation Process", (November 11, 2014) *http://americanactionforum.org/research/reform-principles-for-fsoc-designation-process.*

[8] Satya Thallam, "Reform Principles for FSOC Designation Process (Cont'd)," (January 15, 2015); *http://americanactionforum.org/solutions/reform-principles-for-fsoc-designation-process-contd.*

TABLE 3. TIMELINE OF FSOC RELATED EVENTS, RULEMAKINGS AND ACTIONS	
July 2010	Dodd-Frank Act Effective
October 2010	1ST FSOC Meeting
	APNR: FSOC's Authority to Require NBFC Regulation/Supervision
January 2011	1ST NPR: FSOC's Authority to Require NBFC Regulation/Supervision
February 2011	RFC: Modifications to the Concentration Limit on Large Financial Companies
April 2011	NPR & RFC: Resolution Plans & Credit Exposure Reports Required by FRB & FDIC
September 2011	FR: Resolution Plans Required by FRB & FDIC
	IFR: Resolution Plans Required for IDIs with > $50 Billion in Total Assets by FDIC
October 2011	2nd NPR: FSOC's Authority to Require NBFC Regulation/Supervision
January 2012	NPR: Enhanced Prudential Standards & Stress Testing For SIFIs By FRB
	FR: Resolution Plans Required for IDIs with > $50 Billion in Total Assets by FDIC
April 2012	FR & IG: FSOC's Authority to Require NBFC Regulation/Supervision
May 2012	RFC: FSOC Hearing Procedures
September 2012	GAO Releases Recommendations to Improve FSOC Process
October 2012	FR: Stress Testing of SIFIs by FRB
November 2012	RFC: FSOC Recommendations to SEC on Money Market Mutual Fund Reform
January 2013	Vote: AIG, GE Capital & Prudential Advanced from Stage 2 to 3
April 2013	Notice: FSOC Amends Hearing Procedures
	NPR: Supervision & Regulation Assessments by FRB
May 2013	Vote: AIG, GE Capital & Prudential Evidentiary Records Completed
June 2013	Vote: AIG, GE Capital & Prudential Designations Approved (10-0; 9-0, 7-2 with Non-Voting State Insurance Rep Also Dissenting)
July 2013	Vote: AIG & GE Capital Designated SIFIs (10-0; 9-0); Hearing Granted To Prudential (9-0)
	Vote: MetLife Advanced from Stage 2 to 3
August 2013	FR: Supervision & Regulation Assessments by FRB
September 2013	Vote: Prudential Designated a SIFI (7-2 with Non-Voting State Insurance Rep Also Dissenting)
March 2014	FR: Enhanced Prudential Standards from FRB
May 2014	Vote: FSOC Adopts Amendments to Transparency Policy & Updated Bylaws for Council's Deputies Committee
	FSOC Holds Public Conference on Asset Managers
	NPR: Concentration Limits on Large Financial Companies from FRB
July 2014	Annual Reevaluation: AIG & GE Capital Maintain SIFI Designation
	NPR & RFC: Amendments to the Capital Plan & Stress Test Rules by FRB
August 2014	Vote: MetLife Evidentiary Record Completed
September 2014	Vote: MetLife Designation Approved (9-0 with Non-Voting State Insurance Rep Expressing Concern)
October 2014	Vote: Hearing Granted to MetLife (10-0)
	FR: Capital Plan & Stress Test Rules from FRB
November 2014	Annual Reevaluation: Prudential Maintains SIFI Designation (8-1)
	GAO Releases Further Recommendations to Improve FSOC Process
	FR: Concentration Limits on Large Financial Companies From FRB
December 2014	Vote: MetLife Designated a SIFI (9-1 with Non-Voting State Insurance Rep Opposing)
	RFC: Asset Management Products & Activities
	Insurance Capital Standards Clarification Act of 2014 Becomes Law
	RFC: Applying Enhanced Prudential Standards to GE Capital
January 2015	MetLife Files Lawsuit Challenging FSOC Designation
	FSOC Reviews Staff Recommendations for Process Changes
February 2015	Notice: FSOC Adopts Supplemental Procedures For NBFC SIFI Determinations
	Extension of Comment Period for Asset Management Products & Activities
Note: Advanced Notice of Proposed Rulemaking (ANPR), Notice of Proposed Rulemaking (NPR), Interim Final Rule (IFR), Final Rule (FR) Request for Comment (RFC) & Interpretive Guidance (IG)	

Primary Criticisms and Recommended Changes

Established in Section 113 of the Dodd-Frank Act, FSOC has been given the difficult task of identifying and monitoring threats to U.S. financial stability in real-time. However, there is no single or simple way to measure and mitigate systemic risk. In fact, the process FSOC has developed to designate NBFCs as SIFIs can also disrupt markets and impose unnecessary regulatory burdens and costs that outweigh its benefits to the economy. So despite recent improvements, FSOC's process needs more rigorous quantitative analysis, respect for other regulators and their expertise, greater concern for market impacts, and a clear path for the removal of a designation. Here is further detail on the issues FSOC reforms should address:

1. FSOC's lack of transparency and failure to provide meaningful information on the determinants leading to designation result in unclear guidance on systemic threats. While FSOC is right to worry about the effect of leaks and disclosures of proprietary information, room still exists for the release of more information detailing issues in the broadest, macro terms. According to a report issued by the Government Accountability Office (GAO), "FSOC's transparency policy states its commitment to operating transparently, but its documentation has not always included certain details."[9] GAO recommended, "To enhance disclosure and strengthen transparency, the Secretary of the Treasury, in consultation with FSOC members, . . . should include additional details in its public basis documentation about why FSOC determined that the company met one or both of the statutory determination standards."[10] Designation decisions available to the public should reflect the shared goal of minimizing systemic threats; if there is a specific activity or subsidiary of a designated firm that poses an acute threat, the final decision should disclose it. Furthermore, GAO is not alone in suggesting more open communication with the public and companies under consideration, the Bipartisan Policy Center and many others have echoed such concerns.[11]

2. If there is a particular activity or activities that threaten the financial system, a company should be able to work with FSOC to remediate the problem. As a company moves through FSOC's 3-stage evaluation process, FSOC does not inform companies of what changes could be made to either their structure or operations to avoid designation. While FSOC has outlined the characteristics it considers in its evaluation process, it is still not clear the weight they give to certain factors over others or what makes a designation more likely. In the supplemental procedures adopted in February, FSOC made some effort toward increasing the amount of communication between firms under consideration and FSOC staff. Yet ultimately, the Council does not encourage companies to work with the Office of Financial Research and FSOC staff to clearly define a potential systemic threat through data and modeling, explore lower cost alternatives to designation, and then move forward if a company cannot remediate the problem. In meeting its aim of financial stability, FSOC should consider all the tools available instead of quickly moving to designation.

3. FSOC should consider the effectiveness of existing primary regulators and defer to their expertise when designating nonbanks. While FSOC is comprised of relevant financial regulators, each one has different expertise and experience. A firm's primary regulator should be given an enhanced role in designation proceedings. Thus far this has not been the case; insurance company designations proceeded with little respect for State regulators and over the objections of FSOC's voting and nonvoting members with insurance expertise.[12]

4. FSOC's institution-by-institution approach engenders disparate treatment and misses the key issue, identifying activities and practices that generate systemic risks. After designating AIG, Prudential Financial and MetLife, FSOC appeared it would move next to asset managers. Yet that institution-by-institution approach misses the key issue: what specific activities or practices generate systemic risks? In this regard, activity-based regulation is more comprehensive as it will identify all of the market participants engaged in an activity that could pose a threat to stability. This is substantially better than singling out one or a few large firms or funds for des-

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[9] GAO, "Financial Stability Oversight Council: Further Actions Could Improve the Nonbank Designation Process", (November 20, 2014); *http://www.gao.gov/products/GAO-15-51.*

[10] Ibid.

[11] Bipartisan Policy Center, Economic Policy Program—Financial Regulatory Reform Initiative, "Dodd-Frank's Missed Opportunity: A Road Map for a More Effective Regulatory Architecture", (April 2014); *http://bipartisanpolicy.org/library/report/dodd-frank's-missed-opportunity-road-map-more-effective-regulatory-architecture.*

[12] See FSOC's Meeting Minutes for September 19, 2013 and December 18, 2014: *http://www.treasury.gov/initiatives/fsoc/council-meetings/Documents/September__19__2013__Notational__Vote.pdf* and *http://www.treasury.gov/initiatives/fsoc/council-meetings/Documents/December__18__2014__Meeting__Minutes.pdf.*

ignation, which creates disparities in regulation across firms and sectors that could have a very real and unintended economic costs. Positively, FSOC has shown it is open to an activity-based approach in assessing the risks posed by asset managers. However, FSOC has acted inconsistently thus far in its approach to insurance companies. [13]

5. Designation decisions must be supported by evidence, rooted in rigorous economic analysis, and backed by statutory authority. In his dissent from the FSOC's SIFI designation of Prudential Financial, Roy Woodall, appointed by President Obama as FSOC's independent member with insurance expertise, noted his concerns about the analytical rigor of the designation process stating, "The underlying analysis utilizes scenarios that are antithetical to a fundamental and seasoned understanding of the business of insurance." [14] John Huff, the nonvoting member of the Council representing State insurance regulators, echoed Woodall's concerns, writing in his dissent, "The analysis contained in the basis for the final determination in large part relies on nothing more than speculation." [15] Experts have further argued that the analytical processes behind designations are generally far too opaque and likely insufficient. [16] Additionally, FSOC has stated it does not intend to "conduct cost-benefit analyses in making determinations with respect to individual nonbank financial companies," reflecting how recent designations have failed to accurately assess the implications of SIFI designations on the insurance industry. [17]

FSOC should attempt to fully assess the economic effect, both costs and benefits, of designating only certain nonbanks as SIFIs. This means producing a convincing model that a firm's failure, its financial distress, or its activities could destabilize the financial system. In such a way, FSOC can demonstrate what is at stake and how a designation will help, and then justify the costs. Preventing the next financial crisis may undoubtedly have enormous benefit, but FSOC has not clearly outlined how each firm or industry segment it has scrutinized poses an actual threat to stability. Since the economic cost of eliminating systemic risk entirely is prohibitive, FSOC's goal must be to find the "right" amount of risk, a difficult feat since FSOC can neither measure its progress nor know its target. Because of the difficulty of regulating entities posing only a potential systemic threat, designations should be firmly rooted in sound economic analyses that explore all costs and benefits (as well as alternatives to designation) and be substantially justified by applicable Dodd-Frank Act statutes.

6. Annual reevaluation should not be a check-the-box exercise, but a genuine opportunity for a nonbank SIFI to address Council concerns and exit designation. SIFI designation should not be indefinite. FSOC must create a process that permits firms to address risks and avoid designation. Once designated, FSOC revisits the designation annually and must vote only to rescind, creating little more than a check-the-box exercise. SIFIs should have a way to "de-risk," address the concerns or activities raised by FSOC that merited a designation, and follow an exit ramp from SIFI status. Whether through sunset provisions or other policy options, the changes announced in February do not go far enough to tackle this issue.

7. FSOC and its staff must continue to actively engage the public, experts, and stakeholders to comprehensively examine potential systemic threats, firm types, and changes in the financial economy environment as well as areas for FSOC procedural improvement. Last fall FSOC began the process of reviewing and evaluating its SIFI designation process for nonbanks, seeking input from stakeholders and assessing potential changes. Ultimately, this process led to the adoption of a number of positive steps toward increasing communication between FSOC staff and firms under review and adding transparency to the process. If anything, this should encourage FSOC to continue to collaborate with stakeholders, seek input from the public, and con-

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[13] For a more thorough discussion, see Satya Thallam, "Considering an Activity-Based Regulatory Approach to FSOC", (September 12, 2014) *http://americanactionforum.org/research/considering-an-activity-based-regulatory-approach-to-fsoc.*

[14] Roy Woodall, "Views of the Council's Independent Member Having Insurance Expertise", (Sept. 2013); *http://www.treasury.gov/initiatives/fsoc/council-meetings/Documents/September 19 2013 Notational Vote.pdf.*

[15] John Huff, "View of Director John Huff, the State Insurance Commissioner Representative", (Sept. 2013); *http://www.treasury.gov/initiatives/fsoc/council-meetings/Documents/September%2019%202013%20Notational%20Vote.pdf.*

[16] Peter Wallison, American Enterprise Institute, "What the FSOC's Prudential Decision Tells Us About SIFI Designation", (March 2014); *http://www.aei.org/outlook/economics/financial-services/banking/what-the-fsocs-prudential-decision-tells-us-about-sifi-designation/.*

[17] "Authority To Require Supervision and Regulation of Certain Nonbank Financial Companies", 77 *Fed. Reg.* 21640 (April 11, 2012) (Amending 12 CFR 1310); *https://federalregister.gov/a/2012-8627.*

tinue to advance efforts that open up its opaque process. As FSOC considers increasingly different potential threats, firms, and industry changes, engagement with outside experts will be integral and may substantially improve public confidence in its efforts.

8. The Federal Reserve's role as chief regulator of designated firms will likely endanger and diminish its independence, which should concern lawmakers. The Federal Reserve Board is the chief regulator of all firms designated as SIFIs, whether insurance companies, asset managers, or something else. While the Federal Reserve is a world-class monetary authority and quality bank regulator, it may struggle to tailor regulations for other financial companies outside of its expertise. This will also likely lead to greater scrutiny by the Congress and endanger central bank independence. In addition to the designation process, it may behoove policymakers to consider primary regulators in an enhanced supervisory role instead of the Federal Reserve Board.

At a minimum, FSOC must conduct its business in a way that is analytically sounder and better grounded in the data and regulatory history, with a clear path away from SIFI designation for nonbanks. Thank you and I look forward to answering your questions.

PREPARED STATEMENT OF DENNIS M. KELLEHER

PRESIDENT AND CEO, BETTER MARKETS, INC.

MARCH 25, 2015

Thank you Chairman Shelby, Ranking Member Brown, and Members of the Committee for the opportunity to provide Better Markets' views about the Financial Stability Oversight Council (the Stability Council).

Better Markets is a nonprofit, nonpartisan organization that promotes the public interest in the domestic and global capital and commodity markets. It advocates for transparency, oversight, and accountability with the goal of a stronger, safer financial system that is less prone to crisis and failure, thereby eliminating or minimizing the need for more taxpayer funded bailouts. To do this, Better Markets engages in the rulemaking process, public advocacy, independent research, and litigation. For example, it has filed more than 150 comment letters in the U.S. rulemaking process related to implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) and has had dozens of meetings with regulators. Our Web site, www.bettermarkets.com, includes information on these and the many other activities of Better Markets.

I am the President and CEO of Better Markets. Prior to starting Better Markets in October 2010, I held three senior staff positions in the Senate: Chief Counsel and Senior Leadership Advisor to the Chairman of the Democratic Policy Committee; Legislative Director to the Secretary of the Democratic Conference; and Deputy Staff Director and General Counsel to what is now known as the HELP Committee. Previously, I was a litigation partner at the law firm of Skadden, Arps, Slate, Meagher, & Flom, where I specialized in securities and financial markets in the U.S. and Europe. Prior to obtaining degrees at Brandeis University and Harvard Law School, I enlisted in the U.S. Air Force while in high school and served 4 years active duty as a crash-rescue firefighter. I grew up in central Massachusetts.

"No More AIGs"

Yesterday, March 24, was the 6 year anniversary of the testimony given by then Treasury Secretary Timothy Geithner and then Federal Reserve Chairman Ben Bernanke before the House Financial Services Committee on the American International Group (AIG) bonus controversy. The surprise and shock of the U.S. having to bailout a private, international insurance conglomerate like AIG with about $185 billion was compounded by the disgust at AIG for nonetheless paying bonuses to some of its employees who were involved in the reckless trading that led to the collapse of the company and the need for it to be bailed out in the first place.

Triple-A rated AIG's involvement in hundreds of billions of dollars of complex, high risk derivatives gambling was a total surprise in September 2008. No one (outside of the too-big-to-fail Wall Street banks that were its counterparties) had any idea that AIG was in that line of business or, more shockingly, had not reserved or set aside anything close to sufficient amounts to cover any potential losses. Given these facts, and its extensive interconnectedness with the entire U.S. and global banking and finance systems, its inability to cover its own derivatives gambling losses unexpectedly threatened the collapse of the U.S. and world economies.

The result was an historic, unlimited bailout where, initially, the U.S. Government effectively threw money into the massive hole AIG created: first, $85 billion,

then a week later another $85 billion, ultimately reaching about $185 billion in cash bailouts. It is fitting that we are here 6 years later discussing the Stability Council because its very existence and purpose is to prevent a situation like AIG from ever happening again.

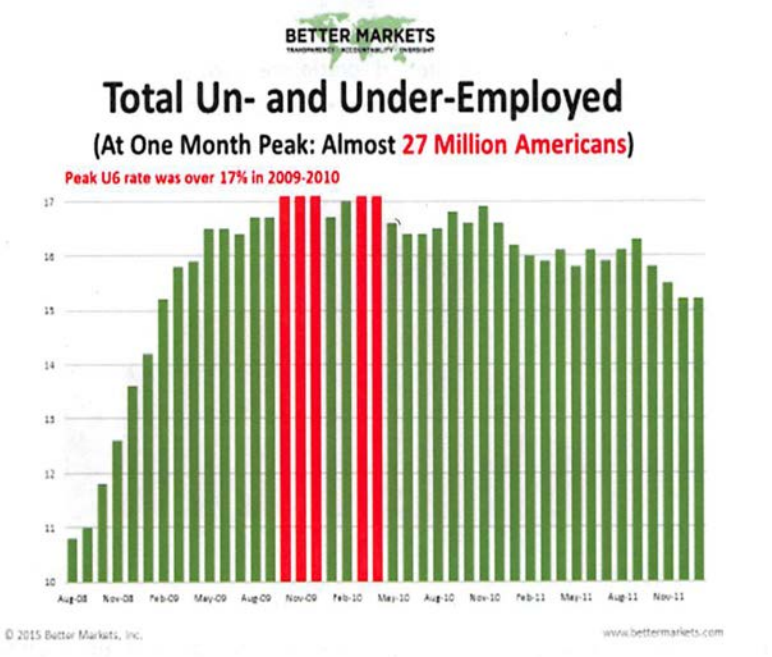
"No more AIGs" should be the Stability Council's motto. Never again should a private company appear out of nowhere and threaten to collapse the entire U.S. and global financial systems. Never again should the U.S. Treasury or taxpayers have to cover the losses of a private company that threaten the stability of our economy or the living standards of our citizens.

And, most importantly, never again should the U.S. have to suffer the consequences of future AIGs: the devastating economic wreckage inflicted on Americans from coast to coast who lost their jobs, homes, savings, retirements, educations, and so much more. As Better Markets has documented, the 2008 crisis will cost the U.S. more than $12 trillion in lost economic output [1] That too is why the Stability Council was created, and is an important part of its mission.

No More Economic Calamities From Unexpected Collapses of Companies That Threaten the Stability of the United States

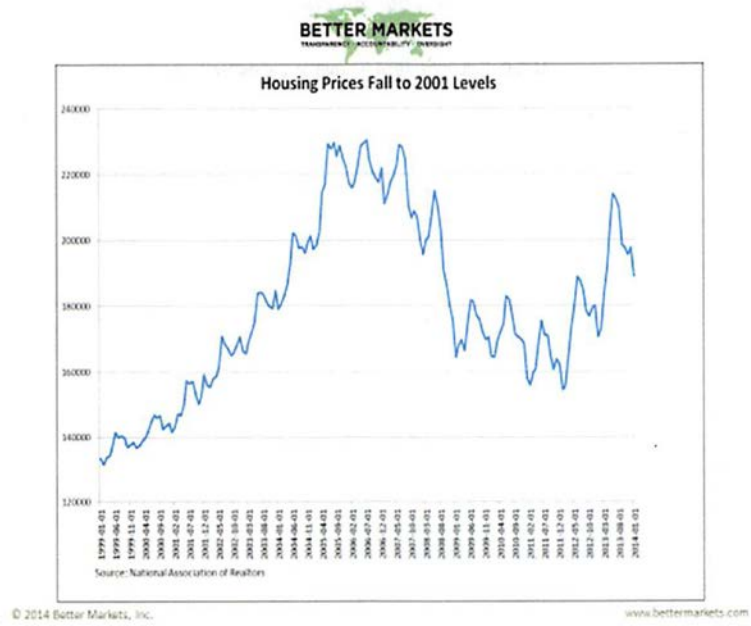
While only a few short years ago, too many have forgotten—or choose to ignore—that the 2008 crash was the worst financial crash since the Great Crash of 1929 and caused the worst economy since the Great Depression of the 1930s. Just a few highlights of that economic wreckage:

- Unemployment and under-employment skyrocketed, peaking in late 2009, early 2010 to a rate of over 17 percent. The one-month peak of what is referred to as the "U6" rate was almost 27 million Americans out of work or forced to work part time rather than fill time as shown below:

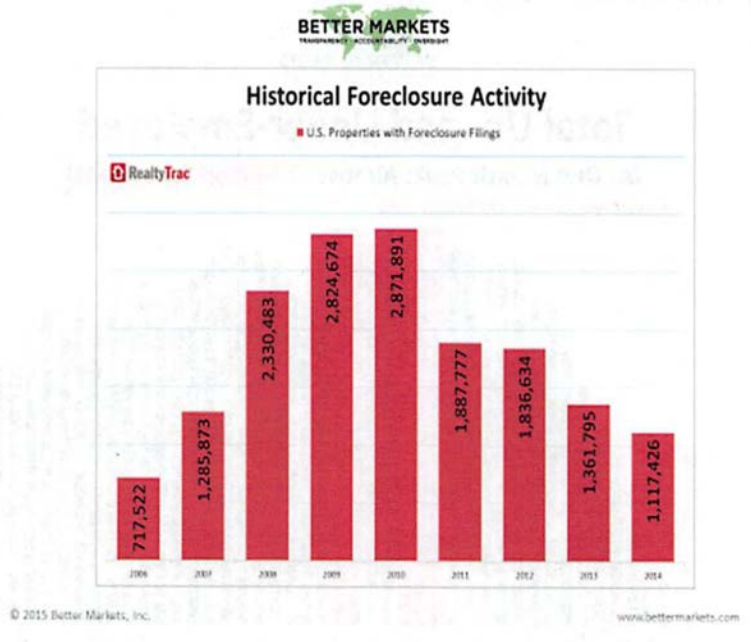


- Housing prices collapsed to 2001 levels and have remained at persistently low levels far beyond the official end of the recession:

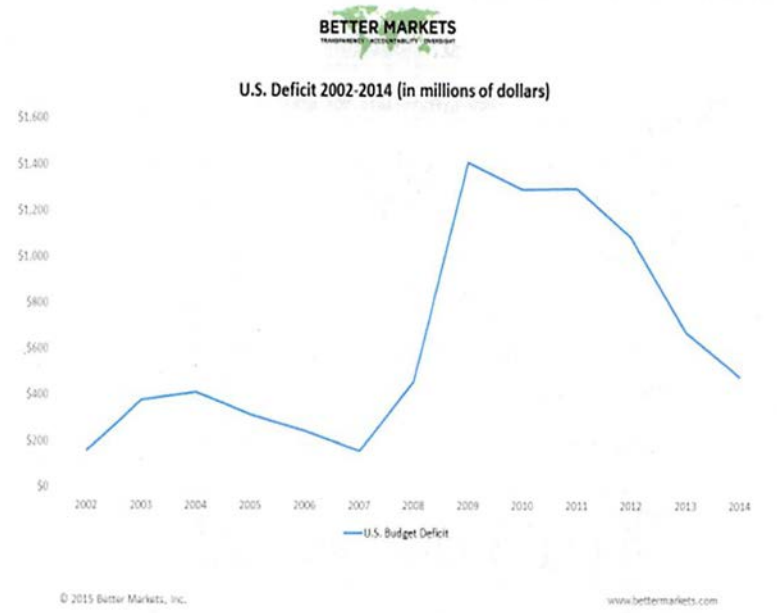
[1] Better Markets, "The Cost of the Wall Street-Caused Financial Collapse and Ongoing Economic Crisis Is More Than $12 Trillion" (Sept. 15, 2012), available at *http://bettermarkets.com/sites/default/files/Cost%20of%20The%20Crisis__2.pdf.*

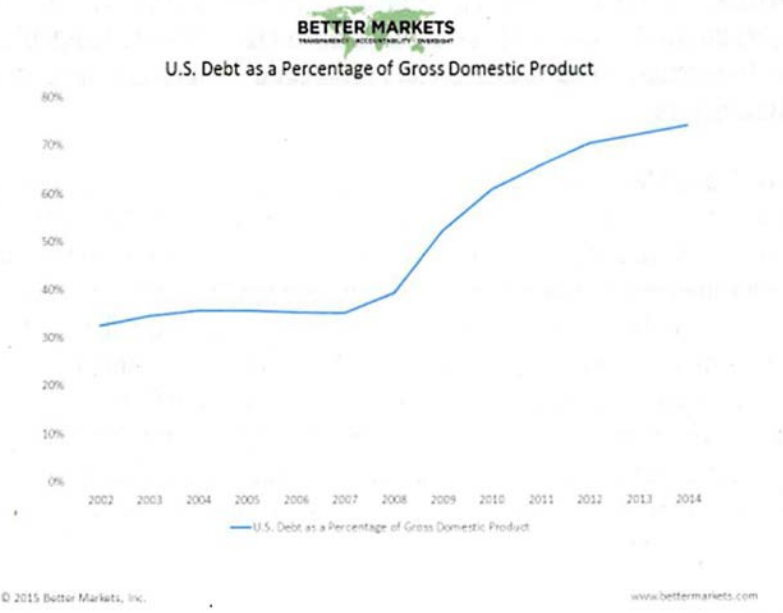


- Americans experienced foreclosure at record rates:



- Tax revenues plummeted at the Federal, State, and local level, and essential spending on social needs skyrocketed as layoffs exploded, causing the deficit and debt to dramatically increase:





This massive economic wreckage resulted from the financial crash of 2008 and the near collapse of the U.S. and global financial systems. The Stability Council was created to be an early warning system to help detect and prevent this type of financial, economic, and human calamity from ever happening again.

With that as the essential context for understanding and thinking about the Stability Council, the testimony that follows addresses three main points:

1. Congress created the Stability Council in response to the catastrophic failure of unregulated systemic threats like AIG, and the Stability Council's success is vital to strengthening the financial system and economy while reducing future systemic threats.
2. The Stability Council's implementation of Section 113 of the Dodd-Frank Act shows that it is using its power deliberatively and judiciously. And, recent significant changes demonstrates it is listening and responding appropriately to constructive input from stakeholders.
3. Additional proposals to change the Stability Council would impair or cripple its ability to protect American families, workers, and taxpayers from another financial crash and economic calamity.

1. Congress Created the Stability Council in Response to the Catastrophic Failure of Unregulated Systemic Threats Like AIG and the Stability Council's Success Is Vital To Strengthening the Financial System and Economy While Reducing Future Systemic Threats

The Stability Council was created to close the gigantic gap in the regulatory system that arose from changes in the financial industry and the regulatory rollbacks of the late 1990s. In particular, following Congressional passage of the Gramm-Leach-Bliley Act and the Commodity Futures Modernization Act, banks, investment firms, derivatives dealers, and insurance companies became supersized into enormous, complex, global, and interconnected financial companies. While the industry changed dramatically, the regulatory system did not, and as a result, on the eve of the 2008 financial crisis our financial regulators focused, at most, on their specific segment of the financial services industry without looking at broader threats and risks. Importantly, none of the regulators were responsible for detecting, addressing, or preventing unseen, unknown, and unexpected risks and threats.

The best known example of this phenomenon was AIG. In 2008 AIG was the world's largest insurance company. However, in addition to selling traditional products like health and life insurance, a division of AIG called AIG Financial Products (AIG FP) accumulated hundreds of billions of dollars of liabilities by selling credit default swaps, a type of derivative that "insured" the buyer of the swap against certain credit risks. This caused AIG to become deeply interconnected through the entire financial system. While AIG's traditional insurance business was overseen by the States, AIG's other lines of business were supposed to be overseen by the Office of Thrift Supervision, a regulator charged with overseeing small savings and loans organizations. Due to competition among regulators, among other reasons, AIG was able to shop around for the weakest regulation possible, which the Office of Thrift Supervision provided in exchange for collecting the fees AIG paid for its regulation.

When the mortgage-backed and other securities AIG FP was "insuring" failed, AIG lacked the capital necessary to fulfill its obligations. The result is well known: the Federal Government was forced to bailout AIG with about $185 billion, take on AIG's obligations, bailout its counterparties including many foreign banks, and enable the payment of $218 million in bonuses to some of AIG FP's executives who were involved in the company's reckless risk-taking in the first place.

AIG's failure, and subsequent bailout, happened in large part because no regulator was responsible for overseeing the systemic risk posed by the firm or, for that matter, posed by any firm. AIG's insurance business was regulated by State insurance commissioners; its thrift was insufficiently regulated by the Office of Thrift Supervision; and its credit default swaps business was largely unregulated due to legal prohibitions on the regulation of such swaps, among other reasons.

That is why, in the immediate aftermath of the crisis, it was very widely agreed that fixing this incredibly consequential regulatory gap required the creation of a single regulator responsible for overseeing systemic risk across the financial system. In fact, following the crisis, politicians and financial industry participants testified to the public and Congress that one of the essential ways of preventing such a crisis from happening again was to create such a systemic risk regulator.

A sample of those statements include the following:

> "We must create a systemic risk regulator to monitor the stability of the markets and to restrain or end any activity at any financial firm that

threatens the broader market."—Henry Paulson, former Secretary of the Treasury [2]

"One of the reasons this crisis could take place is that while many agencies and regulators were responsible for overseeing individual financial firms and their subsidiaries, no one was responsible for protecting the whole system from the kinds of risks that tied these firms to one another."—Robert S. Nichols, President and Chief Operating Officer, Financial Services Forum [3]

"I believe an interagency council with a strong authority in a focused area, in this case monitoring and directing the response to risks that threaten overall financial stability, could, like the [National Security Council], serve the Nation well in addressing complex and multifaceted risks."—Paul Schott Stevens, President and CEO, Investment Company Institute [4]

"A systemic risk regulator that has access to information about any systemically important financial institution—whether a bank, broker-dealer, insurance company, hedge fund or private equity fund—could have the necessary perspective to ensure firms are not exploiting the gaps between functional regulators, or posing a risk to the larger system."—Randolph C. Snook, Executive Vice President, Securities Industry and Financial Markets Association (SIFMA) [5]

"The ABA strongly supports the creation of a systemic regulator. In retrospect, it is inexplicable that we have not had a regulator that has the explicit mandate and the needed authority to anticipate, identify, and correct, where appropriate, systemic problems. To use a simple analogy, think of the systemic regulator as sitting on top of Mount Olympus looking out over all the land. From that highest point the regulator is charged with surveying the land, looking for fires. Instead, we have had a number of regulators, each of which sits on top of a smaller mountain and only sees its part of the land. Even worse, no one is effectively looking over some areas. This needs to be addressed."—Edward L. Yingling, then President and Chief Executive Officer, American Bankers Association [6]

Based in part on this testimony, Congress created the Stability Council as part of the Dodd-Frank Act, and tasked the Stability Council with the mission of identifying and responding to risks to the financial stability of the United States. As such, the Stability Council is the front line macroprudential regulator that serves as the early warning system needed to identify such threats, and address the challenges presented by the shadow-banking system to the financial stability of the U.S.

Congress gave the Stability Council a number of important tools to carry out this mission including the ability to:

- Designate nonbank financial companies as systemically important and subject those companies to supervision by the Federal Reserve
- Make policy and enforcement recommendations to primary financial regulators
- Collect information through the Office of Financial Research
- Publish annual reports about systemic risks to the financial system

In addition, for the first time, the Stability Council enables all of the financial regulators to communicate with each other regularly and gain the benefit of each regulator's expertise. All of these tools provide the Stability Council with the ability to take a holistic view of the financial system, just as the ICI, ABA, SIFMA, and Financial Services Forum, among many others, said was so necessary.

The ability to designate nonbank financial companies for prudential supervision by the Federal Reserve is among the most important tools Congress provided the Stability Council. The ability to designate a company for enhanced supervision is the primary mechanism to prevent any firm or activity—like the derivatives dealing at AIG FP—from slipping through the regulatory cracks. For that reason, ensuring that the Stability Council can continue to adequately and appropriately use this authority is critically important to protecting America's families, workers, savers, communities, taxpayers, financial system, and economy as a whole.

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[2] "How To Watch the Banks", *New York Times* OP-ED (Feb. 15, 2010).
[3] Testimony at House Financial Services Committee (July 17, 2009).
[4] Testimony at Senate Banking Committee hearing (July 23, 2009).
[5] Testimony at House Financial Services Committee (July 17, 2009).
[6] Testimony at House Financial Services Committee (Mar. 17, 2009).

2. The Stability Council's Implementation of Section 113 of the Dodd-Frank Act Shows That It Is Using Its Power Deliberatively and Judiciously. And, Recent Significant Changes Demonstrates It Is Listening and Responding Appropriately to Constructive Input From Stakeholders

Under Section 113 of the Dodd-Frank Act, the Stability Council has the authority to designate a nonbank financial company for enhanced prudential regulation by the Federal Reserve only if it finds that: "material financial distress at the U.S. nonbank financial company, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the U.S. nonbank financial company, could pose a threat to the financial stability of the United States."

Before making such a designation, the Stability Council is required to consider 10 specific factors, plus any other risk-related factors the Stability Council finds appropriate.

To provide a standard method for considering these designations, on April 11, 2012, the Stability Council released a final rule and interpretive guidance implementing a three-stage process for designating nonbank companies for enhanced regulation,[7] outlined below:

- In Stage 1, the Stability Council "narrow[s] the universe of nonbank financial companies to a smaller set" by evaluating the size, interconnectedness, leverage, and liquidity risk and maturity mismatch of nonbanks.
- If a firm has been identified in Stage 1, in Stage 2 the Stability Council then "conduct[s] a robust analysis of the potential threat that each of those nonbank financial companies could pose to U.S. financial stability," based on data from existing public and regulatory sources.
- Finally, if a firm makes it to Stage 3, then the Stability Council conducts a more detailed review using information obtained directly from the nonbank financial company. At this point, the Stability Council, by a two-thirds vote (including that of the Treasury Secretary who is also the Stability Council Chairman), may make a Proposed Determination with respect to any company. A firm subject to a Proposed Determination may request a hearing to contest the determination. After the hearing, the Stability Council may vote, again by two-thirds, to make a Final Determination. Throughout this stage, firms may provide written comments to or meet with Stability Council staff and discuss their potential designation.

Importantly, on February 4, 2015—not 3 years after finalizing its rule and only last month—the Stability Council approved a series of very significant changes to the designation process designed to improve transparency and public accountability.[8] (Those changes are attached as Exhibit A hereto.) Those changes include:

- First, the Stability Council will now engage with companies during the designation process to a greater extent than previously. For example, the Stability Council will notify a company when it is under Stage 2 review, and any such company may provide data for the Stability Council to review prior to Stage 3. The Stability Council will alert companies when they have not been recommended to Stage 3. Finally, the Stability Council will begin communications with a company's primary regulator or supervisor during Stage 2, rather than Stage 3.
- Second, the Stability Council will now more fully engage with designated companies during its annual review of a company's designation to improve the de-designation process. Going forward, if a designated company contests its designation during that annual review, and if the Stability Council votes not to rescind the designation, it will provide the company and primary regulators with an explanation why. This change, and others to the de-designation process, are a significant improvement that will adequately allow a designated company to document that it no longer meets the statutory criteria without harming the Stability Council's ability to protect the financial system, the economy, and the public.
- Finally, the Stability Council will provide increased transparency to the public. Previously, if a company announced it was under consideration for designation,

[7] Financial Stability Oversight Council, "Authority To Require Supervision and Regulation of Certain Nonbank Financial Companies", 77 *Fed. Reg.* 21637 (Apr. 11, 2012).

[8] Financial Stability Oversight Council, "Supplemental Procedures Relating to Nonbank Financial Company Determinations" (Feb. 4, 2015), available at *http://www.treasury.gov/initiatives/fsoc/designations/Documents/Supplemental-Procedures-Related-to-Nonbank-Financial-Company-Detenninations-February-2015.pdf.*

the Stability Council would neither confirm nor deny that. Now, if the company publicly confirms that is under consideration the Stability Council will confirm that upon request to do so by a third party. The Stability Council will also annually publish the number of companies considered for designation along with the number of companies considered but not designated. Finally, the Stability Council has agreed to publish further details of how its Stage 1 thresholds are calculated in the future.

These changes were very significant and telling for two reasons. First, as a matter of process, the Stability Council's actions demonstrate that it listens carefully to those who comment on its activities and responds with meaningful action. Such actions are all too rare and the Stability Council should be applauded for doing so.

Second, as a matter of policy, the changes make the Stability Council's designation determinations better, which will ensure better outcomes for the firms under review and the public. Increased communications between the Stability Council and firms under consideration for designation will enable a more robust, data based decision-making process based on all material information. Additionally, increased public disclosure and transparency will build trust and confidence that the Stability Council is on watch and fulfilling its important role.

In its very short life of less than 5 years, the Stability Council has designated just four nonbank financial institutions for enhanced supervision. In each instance, the Stability Council acted prudently, designating the firm only after conducting a thorough analysis and concluding that each one satisfied the applicable statutory standards. Each fits the requirements for designation by having a systemwide reach and being so interconnected with other financial companies that its failure would cause damage to the financial system and real economy.

The clearest example of this is AIG.[9] AIG was so large and interconnected that, as the subprime bubble burst, its credit default swap portfolio was so large that it became insolvent, unable to pay its counterparties, and had to be bailed out by taxpayers. As the Stability Council said in its public final basis for designating AIG, "Individual exposures to AIG may be relatively small, but in the aggregate, the exposures are large enough that material financial distress at AIG, if it were to occur, could have a destabilizing effect on the financial markets."

Furthermore, AIG and its subsidiary are the reference entities "for a combined $70 billion in notional single-name CDS, which is significant and comparable to several of the largest money-center banks, investment banks, bond insurers, and prime brokers," meaning that its failure would have a large impact on other, non-AIG companies.

Like AIG, GE Capital was so deeply affected by the financial crisis that it required a $139 billion bailout for fear that a collapse would greatly affect other financial firms. In its designation, the Stability Council explained that "there is approximately $77 billion in gross notional credit default swaps outstanding for which GECC is the reference entity:" even larger that the notional value for AIG.[10] Furthermore, GE Capital's portfolio of assets, $539 billion as of December 31, 2012, is "comparable to those of the largest U.S. BHCs." As such, among other things, any rapid liquidation of GE Capital's assets could lead to a fire sale of the securities of other large corporations, including of the largest financial institutions.

The Stability Council also determined that Prudential met the statutory criteria after determining that the financial system is significantly exposed to Prudential "through the capital markets, including as derivatives counterparties, creditors, debt and equity investors, and securities lending and repurchase agreement counterparties."[11] It also found that the complexity and interconnectedness of Prudential would make it difficult for the firm to be resolved, posing a material threat to U.S. financial stability.

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[9] Financial Stability Oversight Council, "Basis of the Financial Stability Oversight Council's Final Determination Regarding American International Group, Inc." (July 8, 2013), available at *http://www.treasury.gov/initiatives/fsoc/designations/Documents/Basis-of-Final-Determination-Regarding-General-Electric-Capital-Corporation,-Inc.pdf*.

[10] Financial Stability Oversight Council, "Basis of the Financial Stability Oversight Council's Final Determination Regarding General Electric Capital Corporation, Inc." (July 8, 2013), available at *http://www.treasury.gov/initiatives/fsoc/designations/Documents/Basis-of-Final-Determination-Regarding-General-Electric-Capital-Corporation,-Inc.pdf*.

[11] Financial Stability Oversight Council, "Basis of the Financial Stability Oversight Council's Final Determination Regarding Prudential Financial, Inc." (Sept. 19, 2013), available at *http://www.treasury.gov/initiatives/fsoc/designations/Documents/Prudential%20Financial%20Inc.pdf*.

The Stability Council made a similar determination in the case of MetLife.[12] In this case, the Stability Council found that there would be a severe negative impact on the financial system if a situation occurred in which MetLife was forced to liquidate its holdings. The Stability Council's public final basis for designating the insurance company states that, "[a] large-scale forced liquidation of MetLife's large portfolio of relatively illiquid assets, including corporate debt and asset-backed securities (ABS), could disrupt trading or funding markets." This is because "[a]s of September 30, 2014, MetLife held $108 billion of U.S. corporate securities at fair value, and $70 billion of asset-backed securities and mortgage-backed securities at fair value." The resulting fire sale would depress prices for the assets MetLife holds, similar to the fire sale which resulted from the Prime Reserve Fund's failure in 2008.

Whatever one wishes to say about the Stability Council's designation process or the decisions it has reached, the Stability Council can hardly be accused of acting hastily or over-broadly. Four designations in less than 5 years is far fewer than what could have been done given the number of nonbank financial companies that failed, received bailouts, or posed systemic risk during the financial crisis just a few short years ago.[13] Furthermore, the three insurance companies designated by the Stability Council are also all listed on the Financial Stability Board's list of Global Systemically Important Insurers, suggesting that the Stability Council's actions are not without merit.

Clearly the Stability Council is acting deliberatively and carefully when considering and making designation determinations.

3. Additional Proposals To Change the Stability Council Would Impair or Cripple Its Ability To Protect American Families, Workers, and Taxpayers From Another Financial Crash and Economic Calamity

Regarding the consideration of any changes to the Stability Council, it must be remembered that it is not even 5 years old. During that time it has had to translate legislative text regarding a stability council into a working reality of the Stability Council. As if that wasn't enough, it had to do so with 15 member agencies, organizations, and departments, with, as is well known, all that entails. And it had to do it from the still smoldering ashes of the financial crash, in the midst of the ongoing economic crisis, and in the face of relentless attacks and criticism.

Frankly, although not perfect, it is a remarkable achievement. In addition, as it did all that, it has listened carefully to those who think it might be able to improve its procedures, including criticism from Better Markets. After careful consideration and deliberation, the Stability Council, as set forth above, has recently adopted a number of very significant changes and those changes should be allowed to be implemented before any additional changes are legislatively imposed on the Stability Council. Given its willingness to listen, change, and improve, the Stability Council deserves no less.

Making matters worse, most of the legislative changes proposed would prevent the Stability Council from carrying out its mission, and would leave our financial system and economy vulnerable to another crisis. Indeed, a number of proposals have recently been put forward that would severely weaken the Stability Council and, in fact, make future AIGs more likely. An overview of those proposals, including an explanation of how they would prevent the Stability Council from fulfilling its critical role follows.

Proposal: Require the Stability Council to make certain decisions within arbitrary time considerations, and force the Stability Council to begin the designation process again unless it meets those time constraints.

Impact: It is in no one's interest for the Stability Council to act in haste. The Stability Council's process for designating a nonbank financial institution should be deliberative and not rushed. Requiring a decision to be made within an arbitrary deadline could put the Stability Council in an untenable situation, potentially forcing them to designate in haste or forego an otherwise necessary and important designation. These scenarios are simply unacceptable, given the importance of Stability Council's mission and the consequences of designation or a failure to designate when appropriate and necessary.

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[12] Financial Stability Oversight Council, "Basis of the Financial Stability Oversight Council's Final Determination Regarding MetLife, Inc." (Dec. 18, 2014), available at *http://www.treasury.gov/initiatives/fsoc/designations/Documents/MetLife%20Public%20Basis.pdf.*

[13] See U.S. Gov't Accountability Office, Rep. No. GA0-11-696, "Federal Reserve System: Opportunities Exist To Strengthen Policies and Processes for Managing Emergency Assistance" (July 2011); *ProPublica*, "Bailout Recipients", available at *https://projects.propublica.org/bailout/list/simple.*

Proposal: Require that the designation of a nonbank financial company be a last resort that is taken only after all other regulatory steps are exhausted.

Impact: This proposal disregards the already very high bar and robust process that the Stability Council must go through before designation (as set forth above and in the law and regulations). It has no reasonable rationale and it would add substantial burdens that would only constrain the Stability Council with no countervailing benefit.

Importantly, designation authority was designed not only to respond to the last crisis, but to be a forward-looking warning system to prevent systemic risks that could cause the next crisis. For that reason, the Stability Council needs the flexibility and discretion to identify new and emerging risks and keep abreast with market developments and financial innovations. Furthermore, these proposals would add yet more unnecessary layers of work for the Stability Council and primary regulatory agencies, creating risky delays that would undermine the Stability Council's mission.

Proposal: Reform the designation process by subjecting it to additional process constraints like cost-benefit analysis.

Impact: Imposing such economic analysis obligations on the Stability Council is as unwise as it is unwarranted. It will only force the Stability Council to engage in an inherently inaccurate yet burdensome process, encumber and delay the Stability Council's work, and ultimately make any designation a more inviting target for legal challenge in court. When applied to financial regulation, cost-benefit analysis is more aptly described as "industry cost-only analysis," in which industry focuses exclusively on the costs of regulation while ignoring the benefits.[14]

The case of designating a firm for enhanced regulation by the Federal Reserve lends itself to just this one-sided analysis, as the designated entity will always be able to cite a long list of specific (if highly questionable) quantifiable costs that would appear to cast designation as unjustifiable. Yet viewed holistically, the benefits of designation are potentially enormous and, in many respects, incalculable, representing the tangible and intangible gains that come from averting another financial crisis, systemic collapse, and untold trillions in bailouts. As traditionally framed, however, cost-benefit analysis does not capture these benefits and does not yield a balanced and accurate picture.

In addition, the process is time-consuming and resource intensive. It will inevitably slow down the designation process and sap the Stability Council's resources, which would be far better spent on its core mission of detecting and analyzing potential risk and responding appropriately.

Finally, a cost-benefit requirement will also make it easier for a designated company to litigate the designation, just as industry groups have relentlessly challenged Securities and Exchange Commission and Commodity Futures Trading Commission regulations alleging insufficient analysis of costs and benefits relating to mutual fund governance, conflict minerals, and position limits. As these cases demonstrate, should Congress choose to require the Stability Council to conduct quantitative cost benefit analysis it would cause a litigation bonanza, creating yet another opportunity for industry to argue that the costs imposed upon them should be more highly prioritized than the benefit to the public of preventing a future crash. This would severely weaken the Stability Council's ability to protect the public and carry out its congressionally directed mandates.

Proposal: Give the primary regulator heightened deference in the designation process.

Impact: No one questions that a company's primary regulator may have significant insights into the workings of that industry and that the primary regulator can provide much needed assistance in understanding the nuances of a company's balance sheet, activities, risks and related issues. However, that regulator may not be in the best position to decide whether the company poses a systemic risk, since they lack the broader perspective that the Stability Council was created to provide. It is also undeniable that individual regulators may bring certain biases to bear, stemming from a sense of "turf" or a desire to downplay the systemic risks that may have evolved under their "watch." There is also the well-known problem of regulatory capture. Thus, the primary regulator may oppose actions that would otherwise be necessary to protect the public from systemic risks. In short, the statutory framework already requires the Stability Council to consult the primary regulator for any entity being considered for designation, and requiring any further deference would be unnecessary and counterproductive.

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[14] Better Markets, "Setting the Record Straight on Cost-Benefit Analysis and Financial Reform at the SEC" (July 30, 2012), available at *http://www.bettermarkets.com/sites/default/files/Setting%20The%20Record%20Straight.pdf.*

Proposal: Delay the Stability Council's ability to designate a firm for enhanced regulation until the Federal Reserve explains what enhanced measures it will impose as a result of the designation.

Impact: Two of the core purposes of the Stability Council are to identify and respond to risks to the financial stability of the United States. By law, the Stability Council has the authority to do so by designating companies as systemically important This authority differs significantly from that of the Federal Reserve, which must determine how best to regulate a designated company. Because the duties of these two agencies are different, the Stability Council should not be required to wait for the Federal Reserve before carrying out its legal obligations. The systemic importance of a company, and the Stability Council's decision to designate it as such, should not be dependent upon or influenced by how the company might or might not be regulated after designation.

Proposal: Change the method by which the Stability Council votes.

Impact: The key decisions made by the Stability Council already require super majorities. These decisions are complex and require a great deal of judgment over which reasonable minds might disagree. While the Stability Council should—and does—strive for consensus, there may come a time when some members oppose an action while a super majority of seven believe the risk to financial stability warrants action. It would be a serious mistake if the Stability Council were unable to go forward under this scenario, preventing action and putting our financial system to significant risk.

Proposal: Expand the number of members on the Stability Council, either by increasing membership or by requiring regulatory agencies to vote to determine how the agency head will vote during Stability Council proceedings.

Impact: The Stability Council already consist of 15 members, 10 voting members and 5 nonvoting members. Expanding it further risks creating a body that is so large it would be ineffective. This would also risk politicizing the decision-making process, turning any Stability Council vote into a partisan exercise and an opportunity for scoring political points. This proposal would therefore lead to unnecessary delays and weaker actions as a result.

Conclusion

Thank you again for the opportunity to appear before you today. I look forward to answering your questions.

EXHIBIT A

Financial Stability Oversight Council

Supplemental Procedures

Relating to Nonbank Financial Company Determinations

February 4, 2015

Background

Section 113 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) authorizes the Financial Stability Oversight Council (the Council) to determine that a nonbank financial company shall be supervised by the Board of Governors of the Federal Reserve System and be subject to enhanced prudential standards if the Council determines that material financial distress at the company, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the company, could pose a threat to the financial stability of the United States.

Over the last several months, as part of the Council's ongoing evaluation of how it conducts its work, the Council has reviewed its practices related to the evaluation of nonbank financial companies under section 113 of the Dodd-Frank Act. This review included engagement with financial companies, trade associations, nonbank financial companies subject to previous Council determinations, public interest groups, and Congressional stakeholders.

Based on this review, the Council has adopted the following procedures that the Council intends to use for determinations in non-emergency situations, to supplement its rule and interpretive guidance regarding nonbank financial company determinations (Rule and Guidance).[1] The Council will continue to work to identify and evaluate additional potential changes to its practices and procedures that would promote active engagement with companies under consideration for a determination and transparency to the public.

The Rule and Guidance provide a detailed description of the analysis that the Council intends to conduct, and the processes and procedures that the Council intends to follow, during its review of nonbank financial companies. In the Rule and Guidance, the Council created a three-stage process for identifying companies for determinations. Each stage of the process involves an analysis based on an increasing amount of information to determine whether a company meets one of the statutory standards for a determination. In the first stage of the process (Stage 1), the Council applies six quantitative thresholds (described in the Rule and Guidance) to a broad group of nonbank financial companies to identify a set of companies that merit further evaluation. In Stage 2, the Council conducts a preliminary analysis of the potential for the companies identified in Stage 1 to pose a threat to U.S. financial stability. Based on the analysis conducted during Stage 2, the Council identifies companies that merit further review in Stage 3, which builds on the Stage 2 analysis with additional quantitative and qualitative analyses. The Council may make a proposed determination regarding a company based on the results of the analyses conducted during this three-stage review. If the Council makes a proposed determination, the

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[1] Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 12 C.F.R. part 1310 (2013).

Council provides the company with notice and an explanation of the basis of the proposed determination. The company may request a hearing to contest the proposed determination. After any hearing, the Council may make a final determination regarding the company.

The Council's evaluation of nonbank financial companies is supported by the staff-level Nonbank Financial Company Designations Committee (Nonbank Designations Committee). The Nonbank Designations Committee is overseen by the Council's Deputies Committee, which is composed of one representative from the staff of each Council member or member agency.

The procedures described below supplement the Rule and Guidance, and are organized into three categories: engagement during evaluations for potential determinations; engagement during annual reevaluations of determinations; and transparency to the public.

Engagement During Evaluations for Potential Determinations

Engagement with Companies

- The Council's practice has been to notify a nonbank financial company under evaluation only if the company is advanced to Stage 3. The Council now will notify a nonbank financial company within 30 days after the Deputies Committee instructs the Nonbank Designations Committee to form an analytical team to commence an active review of the company in Stage 2. Prior to approving a company for active review, the Deputies Committee will consider any preliminary information gathered by the Nonbank Designations Committee.

- A company under active review in Stage 2 may submit to the Council any information it deems relevant to the Council's evaluation and may, upon request, meet with analytical team staff. In addition, analytical team staff will, upon request, provide the company with a list of the primary public sources of information being considered during the Stage 2 analysis, so that the company has an opportunity to understand the information the Council may rely upon during Stage 2.

- If the Council votes to not advance a company from Stage 2 to Stage 3, the Council will notify the company in writing of the Council's decision. The notice will clarify that a vote not to advance the company from Stage 2 to Stage 3 at that time does not preclude the Council from notifying the company in the future that it is again under active consideration in Stage 2.

- If the Council votes to advance a company from Stage 2 to Stage 3, the Council's current practice is to provide the company with an opportunity to submit written materials to the Council to contest the Council's consideration of the nonbank financial company for a proposed determination. In addition, analytical team staff will now meet with the company's representatives at the start of Stage 3 to explain the evaluation process and the framework for the Council's analysis. If the analysis in Stage 2 has identified specific aspects of the company's operations or activities as the primary focus for the evaluation, staff will notify the company of those issues, although the issues will be subject to change based on the ongoing analysis. After this meeting, the Council will provide the company with a request for information that will generally indicate how the requested items relate

to the Council's framework for analyzing potential risks described in the Rule and Guidance.

- Consistent with the Council's current practice, during Stage 3, a company may submit to the Council any information it deems relevant to the Council's evaluation and may request meetings with analytical team staff regarding any issue the company deems appropriate.

- The Council's Deputies Committee will grant a request to meet with a company in Stage 3 on a mutually agreed-upon date, subject to receiving the request at least 30 days prior to the proposed meeting, to allow the company to present any information or arguments it deems relevant to the Council's evaluation.

- Pursuant to the Dodd-Frank Act, the Council can, in its sole discretion, determine whether to grant a request for an oral hearing for any company subject to a proposed determination. The Council intends to grant any timely request for an oral hearing from a company subject to a proposed determination, and for any such hearing to be conducted by the Council members.

Engagement with Existing Regulators

Under the Dodd-Frank Act, the Council must consult with the primary financial regulatory agency, if any, for each nonbank financial company or subsidiary of a nonbank financial company that is being considered for a determination before the Council makes any final determination with respect to such company. The Council's practice has generally been to begin the consultation process in Stage 2 with the primary financial regulatory agencies or home country supervisors, as appropriate, and to consult in Stage 3 with such regulators in a timely manner before the Council makes any final determination with respect to the company.

- For any company under active review in Stage 2 that is regulated by a primary financial regulatory agency or home country supervisor, the Council will notify such regulator or supervisor that the company is under active review no later than such time as the company is notified. The Council will seek to begin the consultation process with such regulator or supervisor during Stage 2, before the Council votes on whether to advance the company to Stage 3.

- In addition, if the Council votes to advance a company to Stage 3, the Council will seek to continue its consultation with such regulator or supervisor during Stage 3, before voting on whether to make a proposed determination regarding the company.

- Further, for any company regulated by a primary financial regulatory agency or home country supervisor, promptly after the Council votes to make a proposed or final determination regarding the company, the Council will provide such regulator or supervisor with the nonpublic written explanation of the basis of the Council's proposed or final determination.

Engagement During Annual Reevaluations of Determinations

- The Council reevaluates each of its determinations not less than annually and will rescind a determination if it determines that the company no longer meets the statutory standards for a determination. Before the Council's annual reevaluation of a nonbank financial company subject to a Council determination, the company will be provided an opportunity to meet with staff on the Nonbank Designations Committee to discuss the scope and process for the review and to present information regarding any change that may be relevant to the threat the company could pose to financial stability, including a company restructuring, regulatory developments, market changes, or other factors.

- If a company contests its determination during the Council's annual reevaluation, the Council intends to vote on whether to rescind the determination and provide the company, its primary financial regulatory agency, and the primary financial regulatory agency of its significant subsidiaries with a notice explaining the primary basis for any decision not to rescind the determination. The notice will address the material factors raised by the company in its submissions to the Council contesting the determination during the annual reevaluation.

- The Council will provide each company subject to a determination an opportunity for an oral hearing before the Council once every five years at which the company can contest the determination.

Transparency to the Public

- The Council's practice has been not to publicly announce the name of any nonbank financial company that is under evaluation for a determination prior to a final determination with respect to such company. However, if a company that is under active review in Stage 2 or that has been advanced to Stage 3 publicly announces the status of its review by the Council, the Council now intends, upon the request of a third party, to confirm the status of a company's review.

- When the Council makes a final determination, it provides the company with a detailed statement of the basis for the Council's decision and publicly releases a written explanation of the basis for the final determination. The Council is subject to statutory and regulatory requirements to maintain the confidentiality of certain information submitted to it by a nonbank financial company under review for a potential determination.[2] As a result, the Council's public basis cannot include confidential information that was submitted by a company to the Council in connection with the Council's evaluation of the company. Nevertheless, the Council is committed to continuing to set forth sufficient information in its public bases to provide the public with an understanding of the Council's analysis while protecting sensitive, confidential information submitted by the company to the Council.

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[2] See Dodd-Frank Act section 112(d)(5), 12 U.S.C. § 5322(d)(5); 12 C.F.R. part 1310.20(e).

- The Council also will publish in its annual reports the numbers of nonbank financial companies that, since the publication of the Council's prior annual report, (1) the Council voted to advance to Stage 3, (2) the Council voted not to advance to Stage 3, (3) became subject to a proposed or final determination, and (4) in the aggregate are subject to a final determination at that time.

- In addition, the Council will in the coming months publish on its website further details explaining how the Stage 1 thresholds are calculated, which may address issues such as how the Council evaluates the use of various accounting standards for purposes of Stage 1; components of the six Stage 1 thresholds; and practices for calculating the thresholds when incomplete data regarding a company are available.

PREPARED STATEMENT OF GARY E. HUGHES

EXECUTIVE VICE PRESIDENT AND GENERAL COUNSEL, AMERICAN COUNCIL OF LIFE INSURERS

MARCH 25, 2015

Chairman Shelby and Ranking Member Brown, my name is Gary Hughes, and I am Executive Vice President and General Counsel of the American Council of Life Insurers (ACLI). ACLI is the principal trade association for U.S. life insurance companies with approximately 300 member companies operating in the United States and abroad. ACLI member companies offer life insurance, annuities, reinsurance, long-term care and disability income insurance, and represent more than 90 percent of industry assets and premiums.

ACLI appreciates the opportunity to address the procedures governing the designation of nonbank financial companies by the Financial Stability Oversight Council (FSOC). ACLI has a particular interest in the subject matter of this hearing; three of the four nonbank financial companies that have been designated by FSOC for supervision by the Federal Reserve Board are insurance companies, and all of those companies, Prudential, MetLife, and AIG, are members of ACLI. Many ACLI member companies also are actively engaged in asset management, which is a business under active review by FSOC.

Last year, ACLI along with several other national trade associations submitted a petition to FSOC recommending changes to the procedures for designating nonbank financial companies as being subject to supervision by the Federal Reserve Board. In response, FSOC made some needed improvements to the process. Nonetheless, additional reforms to the procedures and standards applied by FSOC in its designations are necessary to promote transparency and ensure a fair process.

My testimony addresses five key points: (1) the additional procedural safeguards that should be adopted by FSOC in connection with designations; (2) FSOC's flawed application of the "material financial distress" standard for designations; (3) FSOC's failure to give sufficient weight to the views of State insurance authorities in connection with designations; (4) FSOC's failure to give consideration to the consequences of designation; and (5) FSOC's failure to consider an "activities-based" approach for insurance. My testimony concludes with recommendations to address these matters.

1. The Designation and De-Designation Processes Lack Sufficient Procedural Safeguards and the Public Explanations Accompanying Designations Give the Public and Other Nonbank Financial Companies Insufficient Insight Into Why Particular Companies Have Been Designated

FSOC has established a three-stage process for determining whether a nonbank financial company should be subject to supervision by the Federal Reserve Board. In response to concerns raised by ACLI and other national trade associations, FSOC has made some improvements to the process. Nonetheless, additional reforms are needed.

A company should have access to the entire record.

A company that advances to the third and final stage of review has no way of knowing what materials FSOC believes are relevant, whether and in what form the materials it submits are provided to voting members of FSOC, or what materials, in addition to those submitted by the company, FSOC staff and voting members reviewed and relied upon. In other words, a company is not provided with the evidentiary record upon which the voting members will make a proposed or final determination. A company should have access to the entire record that is the basis for an FSOC determination.

FSOC should have separate staff assigned to enforcement and adjudicative functions.

Council staff who identify and analyze a company's suitability for designation and author the notice of proposed determination and final determination should not also advise Council members in deciding whether to adopt the notice of proposed determination and final determination. Dividing Council staff between enforcement and adjudicative functions would protect the independence of both functions. Separation of powers principles and basic fairness require no less. In addition, communications between Council members and enforcement staff should be memorialized as part of the agency record and provided to companies under consideration for designation.

Special weight should be given to the views of the Council member with insurance expertise and to the primary financial regulatory agency for a company.

FSOC must vote, by two-thirds of the voting members then serving including the affirmative vote of the Chairperson, to issue a final determination. The requirement for a super majority vote is intended to ensure that designation is reserved for companies that pose the most obvious risk to the financial stability of the United States. Yet, the members of FSOC vote as individuals rather than as representatives of their agencies. Thus, the vote is based upon their own assessment of risks in the financial system rather than the assessment of their respective agencies. Moreover, the voting process gives equal weight to views of all members, regardless of a member's experience in regulating the type of company being considered for designation. In the case of an insurance company, special weight should be given to the views of the Council member with insurance experience, and to the State insurance regulator for the company.

The explanation of a designation should provide greater insight into the basis for designation, and a designation should be based upon evidence and data.

When FSOC votes to designate a company, it provides the company with an explanation of the basis for the determination and releases a public version of that document. These documents provide little insight into the basis for a designation, typically offering only conclusory statements unsupported by data or other concrete evidence and analysis. For example, in the documents released by FSOC in connection with the Prudential and MetLife determinations, FSOC concluded that material financial distress at Prudential and MetLife would be transmitted to other financial firms and harm the financial system. In drawing this conclusion, FSOC relied on extensive speculation about the behavior of policyholders and the reactions of competing insurers and assumed that State regulatory responses would be inadequate, even though history and empirical evidence were to the contrary. When the only explanation for a designation disregards historical experience, empirical research, and fundamental and proven principles of economic behavior and risk analysis, the industry can at best only speculate about the kind of evidence that would satisfy FSOC that designation is neither necessary nor appropriate.

A company should have more than 30 days to seek judicial review of a final decision in a Federal court, and during judicial review, the company should not be subject to supervision by the Federal Reserve Board.

Upon receipt of a final designation, a company may seek judicial review before a Federal court. Even this safeguard, however, is subject to limitations. A company has only 30 days in which to file a complaint, and loses the right to do so beyond that date. Moreover, filing the complaint carries no automatic stay of supervision by the Federal Reserve Board. Thus, while a company is challenging the legitimacy of a designation, it simultaneously must establish a comprehensive infrastructure (e.g., systems, procedures, and controls) to comply with Board supervision.

Companies should be able to petition for a review of a designation based upon a change in operations or regulations, and a company should be provided with an analysis of the factors that would permit it to be de-designated.

FSOC is required to review the designation of a company on an annual basis. A company also should have the opportunity to obtain a review based upon a change in its operations, such as the divestiture of certain business lines, or a change in regulation. Moreover, during a review, FSOC should be required to provide a company with an analysis of the factors that would lead FSOC to de-designate a company. This would lead a company to know precisely what changes in its operations or activities are needed to eliminate any potential for the company to pose a threat to the financial stability of the United States.

FSOC's determinations should be independent of international regulatory actions.

Finally, the lack of transparency in FSOC's designation process and the thinly-reasoned explanations in its designation decisions support the concern voiced by some that FSOC's designations have been preordained by actions of an international regulatory entity, the Financial Stability Board (FSB). The member of FSOC with insurance expertise, Roy Woodall, expressed this concern in his dissent to the Prudential designation. The U.S. Department of Treasury and the Federal Reserve Board are both important participants in the FSB, which in 2013, issued an initial list of insurance companies that the organization considered to be "global systemically important insurers." AIG, Prudential, and MetLife were all on the FSB's list. Those companies' designations as SIFIs should have been based on the statutory requirements of the Dodd-Frank Act, which differ meaningfully from the standards FSB has said it applies. Yet, there is ground for concern that leading participants

in FSOC were committed to designating as systemic under Dodd-Frank those companies that they had already agreed to designate as systemic through the FSB process. FSOC should not be outsourcing to foreign regulators important decisions about which U.S. companies are to be subject to heightened regulation.

2. FSOC's Flawed Application of the Material Financial Distress Standard for Designation Distorts the Purpose of Designations by Failing To Account for the Vulnerability of Prospective Designees and Departs From the Requirements of the Dodd-Frank Act and Its Own Regulatory Guidance

The Dodd-Frank Act authorizes FSOC to designate a nonbank financial company for supervision by the Federal Reserve Board if either (1) material financial distress at the company, or (2) the nature, scope, size, scale, concentration, interconnectedness, or mix of activities of the company could threaten the financial stability of the United States. Each of the designations made by FSOC has been based on the first standard, the material financial distress standard. Moreover, in each case, FSOC assumed the existence of material financial distress at the company, and then concluded that such distress could be transmitted to the broader financial system.

This interpretation of the material financial distress standard departs from the authorizing statute and FSOC's own regulatory guidance, and distorts the purpose of designation. The Dodd-Frank Act expressly directs FSOC, when considering a company for designation, to consider 11 factors, a number of which implicate the company's vulnerability to material financial distress. And FSOC's own interpretive guidance recognizes that a company's vulnerability to financial distress is a critical part of the designation inquiry. [1] The statute, FSOC's guidance, and well-established principles of reasoned regulation make clear that FSOC should not evaluate a company's systemic effects by assuming that the designated company is failing, but instead should separately assess the company's vulnerability to material financial distress. Making this a part of the designation process also provides guidance and the right incentives for companies that may be considered for designation in the future, because it incentivizes them to change aspects of their business that FSOC regards as vulnerabilities.

Roy Woodall addressed FSOC's flawed application of the material financial distress standard in his dissents in both the Prudential and MetLife cases. In the Prudential case, he noted that:

> the Notice's analysis under the [material financial distress standard] is dependent upon its misplaced assumption of the simultaneous failure of all of Prudential's insurance subsidiaries and a massive and unprecedented, lightning, bank-style run by a significant number of its cash value policyholders and separate account holders, which apparently is the only circumstance in which the Basis concludes that Prudential could pose a threat to financial stability. I believe that, absent a catastrophic mortality event (which would affect the entire sector and also the whole economy), such a corporate cataclysm could not and would not occur.

Similarly, in his dissent in the MetLife case, Mr. Woodall highlighted the lack of evidence to support one of FSOC's principal bases for assuming "material financial distress" at MetLife:

> I do not, however, agree with the analysis under the Asset Liquidation Transmission Channel of the Notice of Final Determination, which is one of the principal bases for the finding under the [material financial distress standard]. I do not believe that the analysis' conclusions are supported by substantial evidence in the record, or by logical inferences from the record. The analysis relies on implausible, contrived scenarios as well as failures to appreciate fundamental aspects of insurance and annuity products, and, importantly, State insurance regulation and the framework of the McCarran-Ferguson Act.

One consequence of FSOC's interpretation of the material financial distress standard is that FSOC focuses too narrowly on a company's size. When it passed the designation provisions in the Dodd-Frank Act, Congress never intended a unilateral focus on size. Rather, size is just one of 11 factors that Congress directed FSOC to consider when it designates a company.

Another consequence of FSOC's reliance on the material financial distress standard is that it is difficult for a company, or the public, to understand the basis for

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[1] See "Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies", 77 *Fed. Reg.* 21,637 (Apr. 11, 2012).

a designation. The documents accompanying designations address how the company's failure might impact financial stability, but do not address what hypothetically caused the company to fail in the first place. Thus, a designated company has little, if any, insight into what activities are, in FSOC's view, associated with systemic risk.

Under a material financial distress standard that actually meets the statutory requirements of the Dodd-Frank Act, FSOC would need to employ the 11 statutory factors to first determine whether the company is vulnerable to material financial distress based upon its company-specific risk profile and, if it is, then determine whether the company's failure could threaten the financial stability of the United States. In other words, FSOC should not be able to designate a company on an assumption that it is failing, but instead should only designate a company when a company's specific risk profile—including its leverage, liquidity, risk and maturity alignment, and existing regulatory scrutiny—reasonably support the expectations that the company is vulnerable to financial distress, and then that its distress could threaten the financial stability of the United States. The purpose of designations should be to regulate nonbanking firms that are engaged in risky activities that realistically "could" cause the failure of the firm, not to regulate firms that are not likely to fail.

3. FSOC Does Not Give Sufficient Weight to the Views of Primary Financial Regulatory Agencies

In drafting the Dodd-Frank Act, Congress recognized that many nonbank financial companies are subject to supervision and regulation by other financial regulators. Insurance companies, for example, are subject to comprehensive regulation and supervision by State insurance authorities. Thus, Congress directed FSOC to consult with other primary regulators when making a designation determination, and required FSOC to consider "the degree" to which a company is already regulated by another financial regulator. Congress also gave the Federal Reserve Board authority to exempt certain classes or categories of nonbank financial companies from supervision by the Board, and directed the Board to take actions that avoid imposing "duplicative" regulatory requirements on designated nonbank companies.

FSOC's designation of insurance companies shows little deference to these requirements. In the case of MetLife, for example, FSOC discounted State insurance regulation even after the Superintendent of the New York State Department of Financial Services (NYDFS), Benjamin Lawsky, told FSOC that: (1) MetLife does not engage in nontraditional noninsurance activities that create any appreciable systemic risk; (2) MetLife is already closely and carefully regulated by NYDFS and other regulators; and (3) in the event that MetLife or one or more of its insurance subsidiaries were to fail, NYDFS and other regulators would be able to ensure an orderly resolution.[2] Similarly, in his dissent in the Prudential case, the Council member with insurance experience noted that the scenarios used in the analysis of Prudential were "antithetical" to the insurance regulatory environment and the State insurance company resolution and guaranty fund systems.

This lack of deference to an insurer's primary financial regulator is particularly troubling given the fact that insurance, unlike every other segment of the financial service industry, does not have any of its primary regulators as voting members of FSOC. Moreover, none of the primary regulators of the three insurers that have been designated were "at the table" when FSOC designation decisions were made.

4. FSOC Has Failed To Consider the Consequences of Designation

FSOC has an obligation to consider the consequences of its actions. Administrative law requires that an agency consider the effects of its actions, and the failure to do so can cause a court to void the action. SEC Chair Mary Jo White acknowledged publicly in June that a principle of good policymaking is to know " . . . what is on the other side if I make that decision . . ." and to understand what a decision " . . . actually accomplish[es] in terms of the issue you're trying to solve for."[3] In its determinations to date, however, FSOC has failed to consider the consequences of its designations.

This failure is particularly relevant to designations involving insurance companies. The insurance industry is highly competitive, and the additional regulation imposed upon a designated company can place that company at a significant competitive disadvantage relative to its nondesignated competitors. Capital standards are

[2] Letter to Honorable Jacob J. Lew, Secretary of the Treasury, from Benjamin M. Lawsky, Superintendent, New York State Department of Financial Services, July 30, 2014.

[3] "SEC Chair: Asset Managers Not Overreacting to FSOC", *Politico Pro.* June 22, 2014. *https://www.politicopro.com/financialservices/whiteboard/?wbid=33914.*

the most obvious example. Congress recently clarified that the Board has the ability to base capital standards for designated insurance companies on insurance risk, rather than banking risk. We appreciate very much this Committee's role in effecting that important clarification. At this point, we are waiting on a proposal from the Federal Reserve Board that makes use of this revised statutory provision. Should the Federal Reserve Board impose capital requirements on designated insurers that are materially different from those imposed by the States, designated insurers may find it difficult to compete against nondesignated competitors.

Additionally, FSOC's failure to consider the consequences of designations on insurance companies is at odds with FSOC's "duty" under the Dodd-Frank Act to monitor regulatory developments, including "insurance issues," and to make recommendations that would enhance the "integrity, efficiency, competitiveness, and stability" of U.S. financial markets. [4]

5. FSOC Has Failed To Consider an "Activities-Based" Approach to Insurance

The Dodd-Frank Act gives FSOC two principal powers to address systemic risk. One power is the authority to designate nonbank financial companies for supervision by the Federal Reserve Board. The other power is an "activities-based" authority to recommend more stringent regulation of specific financial activities and practices that could pose systemic risks. FSOC has not been consistent in its exercise of these powers. In the case of the insurance industry, FSOC has actively used its power to designate. In the case of the asset management industry, FSOC has undertaken an analysis of the industry so it can consider the application of more stringent regulation for certain activities or practices of asset managers, and it has not designated any asset management firm to date.

FSOC held a public conference on the asset management industry in order to hear directly from the asset management industry and other stakeholders, including academics and public interest groups, on the industry and its activities. Furthermore, following its meeting on July 31, 2014, FSOC issued a "readout" stating that FSOC had directed its staff "to undertake a more focused analysis of industry-wide products and activities to assess potential risks associated with the asset management industry."

In contrast, FSOC has not held any public forum at which stakeholders could discuss the insurance industry and its activities. Instead, FSOC has used its power to designate three insurance companies for supervision by the Federal Reserve Board.

ACLI supports the more reasoned approach that FSOC has taken in connection with the asset management industry and believes that FSOC should be required to use its power to recommend regulation of the specific activities of a potential designee before making a designation decision with respect to that company.

FSOC's power to recommend more stringent regulation of specific activities and practices has distinctive public policy advantages over its power to designate individual companies for supervision by the Federal Reserve Board. FSOC's power to recommend brings real focus to the specific activities that may involve potential systemic risk and avoids the competitive harm that an individual company may face following designation. As noted above, in certain markets, such as insurance, designated companies can be placed at a competitive disadvantage to nondesignated companies because of different regulatory requirements. Finally, the power to recommend avoids the "too-big-to-fail" stigma that some have associated with designations.

FSOC's recommendations for more stringent regulation of certain activities and practices must be made to "primary financial regulatory agencies." These agencies are defined in the Dodd-Frank Act to include the SEC for securities firms, the CFTC for commodity firms, and State insurance commissioners for insurance companies. A recommendation made by FSOC is not binding on such agencies, but the Dodd-Frank Act includes a "name and shame" provision that encourages the adoption of a recommendation. That provision requires an agency to notify FSOC within 90 days if it does not intend to follow the recommendation, and FSOC is required to report to Congress on the status of each recommendation.

Recommended Reforms

To address the concerns highlighted in this statement, ACLI recommends the following reforms:

[4] §112(a)(2)(D) of the Dodd-Frank Act.

Institute additional procedural safeguards during the designation process.

We recommend the following changes to the designation process: (1) companies that receive a notice of proposed determination should be given access to the entire record upon which FSOC makes the determination to issue the notice; (2) the same FSOC staff should not serve as fact finder, prosecutor and adjudicator; (3) in the case of an insurance company, the views of the Council member with insurance expertise and the primary financial regulatory agency for the company should be given greater weight; (4) a company should be given more than 30 days to initiative judicial review of a final determination; and (5) supervision of the company by the Federal Reserve Board should be stayed during judicial review.

Establish additional procedures for de-designation.

In addition to the mandatory annual review of a determination, FSOC should be required to conduct a review upon the request of a designated company if there has been a change in the operations of the company or a change in regulation affecting the company. In connection with such a review, FSOC should also provide a company with an analysis of the factors that would lead FSOC to de-designate the company. This would permit a company to know precisely what changes in its risk profile are needed to eliminate any potential for the company to pose a risk to the financial stability of the United States. Finally, during the de-designation review, the views of the Council member with insurance expertise and the primary financial regulatory agency for the company should be given special weight.

Require FSOC to pursue an "activities-based" approach before using its power to designate a company for supervision by the Federal Reserve Board.

FSOC should use its authority under the Dodd-Frank Act to recommend specific activities and practices for more stringent regulation before designating individual nonbank financial companies within an industry for supervision by the Federal Reserve Board. More stringent regulation of the activities or practices of an entire class or category of financial firms can have a greater impact on financial stability than the designation of an individual firm.

Require FSOC to consider "vulnerability" in its designation decisions.

The statute, FSOC's own regulatory guidance, and common sense dictate that a company should not be designated systemic without an evaluation of whether the company, as currently structured and operated, is indeed vulnerable to material financial distress. Steps should be taken to ensure that FSOC makes this factor an element of its decision-making process in the future.

Promulgate the regulations required by Section 170 of the Dodd-Frank Act.

Section 170 of Dodd-Frank directs the Federal Reserve Board, in consultation with FSOC, to issue regulations exempting certain classes or categories of companies from supervision by the Federal Reserve Board.[5] However, to date no such regulations have been issued pursuant to this authority. This requirement represents yet another tool Congress created to delineate between those entities that pose systemic risk and those that do not. How such regulations might affect insurance companies, if at all, is unknown. But presumably the regulations will shed additional light on what metrics, standards or criteria operate to categorize a company as nonsystemic. The primary goal here should be to clearly inform companies of how to conduct their business and structure their operations in such a way as to be nonsystemic. Only if that primary goal cannot be met should the focus turn to regulating systemic enterprises.

Conclusion

Mr. Chairman, we believe the best interests of the U.S. financial system and the stated objectives of the Dodd-Frank Act can be realized most effectively by an FSOC designation process that operates in a more transparent and fair manner. The overarching purpose of the Dodd-Frank Act is to minimize systemic risk in the U.S. financial markets. Providing companies with the choice and the ability to work constructively with FSOC to structure their activities in such a way as to avoid being designated as systemic in the first instance advances that purpose and reflects sound regulatory policy—as would affording companies a viable opportunity for de-designation. The reforms we are recommending are intended to achieve these objectives, and we pledge to work with this Committee and others in Congress toward that end.

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[5] §170 of the Dodd-Frank Act.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR VITTER FROM JACOB J. LEW

Q.1. Secretary Lew, FSOC recently announced changes to its designation procedures, including a new effort to notify companies that they are being considered for designation earlier in the process.

Can you explain what prompted FSOC to amend its procedures? Will those amended procedures be used to reevaluate companies that have already been designated under the prior FSOC regime?

A.1. The FSOC is committed to the continued evaluation of its procedures and to engagement with stakeholders. Our adoption of supplemental procedures to the nonbank financial company designations process represents the latest example of the FSOC's willingness to revisit how it conducts its work, based on ideas raised by stakeholders, without compromising the FSOC's fundamental ability to achieve its mission. Last fall, FSOC conducted extensive outreach with a wide range of stakeholders about potential changes to its process. The FSOC Deputies Committee hosted a series of meetings in November with more than 20 trade groups, companies, consumer advocates, and public interest organizations. We also solicited input from each of the three companies then subject to a designation. FSOC discussed the findings from this outreach and potential changes during a public meeting in January, and adopted the supplemental procedures in February.

The supplemental procedures provide greater public transparency regarding the FSOC's process. Many of these procedures reflect practices that were already used in the evaluation of companies that were previously designated by the FSOC. With regards to the supplemental procedures applicable to annual reevaluations of previously designated companies, the changes will enhance the FSOC's already-robust process for reviewing each previous designation.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR TOOMEY FROM JACOB J. LEW

Q.1. FSOC's 2014 annual report notes that the Council is charged with promoting market discipline by eliminating the expectation of bailouts in the event of a failure of a large financial company. In pursuing that mandate, the Council has designated a number of nonbank financial companies as SIFIS, which subjects them to additional supervision by the Federal Reserve. While increased supervision may allow regulators to better understand and manage the perceived systemic risk these firms present, many market participants may view SIFI designation as a signal that a firm is in fact too-big-to-fail and would receive Government assistance in the event of its imminent failure. With that in mind, one goal of the nonbank designation process might be voluntary de-risking by SIFIs and potential SIFIs.

Does FSOC provide any guidance to companies under review on steps that they could take voluntarily in order to reduce their systemic importance and avoid designation?

In its annual reevaluation of designated companies, does FSOC provide those companies with actionable guidance on the steps necessary to remove their SIFI designation? If not, should it?

During the hearing, Chairman Shelby asked about giving firms the opportunity to "work their problems out." You responded: "I think that in its wisdom Congress created a process for these matters to be decided and resolved and adjudicated, and that process should stand." Please expand upon that response to explain why the designation process should not include an opportunity for firms to work with FSOC to voluntarily reduce risk and avoid designation.

A.1. When evaluating a nonbank financial company for potential designation, the FSOC engages extensively with the company to understand and consider any ways in which the firm's material financial distress could pose a threat to U.S. financial stability. For past designations, FSOC has engaged with the company during a period ranging from 10 to 17 months. As part of its engagement, the FSOC provides the company with a detailed explanation of the basis for any proposed designation, which can include hundreds of pages of company-specific analysis. Prior to any final designation by the FSOC, companies have an opportunity for a hearing before the FSOC. Upon a final designation, the FSOC provides the company with a detailed written explanation of the basis for the designation that specifically describes the potential risks identified by the FSOC in its evaluation.

For each of the four nonbank financial companies that the FSOC has designated since the enactment of the Dodd-Frank Act, the FSOC determined, based on its consideration of the 10 statutory factors set forth in the Dodd-Frank Act, that the company's material financial distress could pose a threat to U.S. financial stability. Those statutory factors include, among others, size, assets, leverage, interconnectedness, and existing regulatory scrutiny. The extensive engagement with companies and existing regulators during the designation process, and the detailed written explanations provided by the FSOC both before and after a final designation, allow companies and their regulators to take steps to address the potential risks identified by the FSOC.

In addition to the engagement and explanations provided to firms in connection with a designation, the FSOC has a robust process to reevaluate each previous designation at least annually. We take these reviews seriously, and the FSOC will rescind the designation of any company if the FSOC determines that it no longer meets the statutory standard for designation. Before the FSOC's annual reevaluation of a firm subject to a designation, the company has the opportunity to meet with FSOC staff to discuss the scope and process for the reevaluation and to present information regarding any relevant changes, including a company restructuring, regulatory developments, market changes, or other factors. If a company contests its designation during the FSOC's annual reevaluation, the FSOC's supplemental procedures state that it intends to vote on whether to rescind the designation and provide the company, its primary financial regulatory agency, and the primary financial regulatory agency of its significant subsidiaries with a notice explaining the primary basis for any decision not to rescind the designation. The notice will address the material factors raised by the company in its submissions to the FSOC contesting the designation during the annual reevaluation. In addition, the FSOC

provides each designated company an opportunity for an oral hearing to contest its designation every 5 years.

Q.2. In considering the overall regulatory regime of the financial system, what would signal that it is sufficiently regulated, under-regulated, or over-regulated?

Since the passage of Dodd-Frank, de novo bank charters have all but ceased, perhaps in part because of the high regulatory hurdles facing small institutions. In response, this Committee has spent a great deal of time considering how it can right-size regulatory touch for smaller firms. Do you support tailoring regulations for small firms and is there any legislative action that you would recommend to relieve pressure on small firms without unduly increasing their risk and systemic risk?

A.2. Policymakers should be attentive to the benefits and burdens of financial regulations that are put forward, including as they relate to community banks. In crafting and implementing Dodd-Frank, Congress and the Federal regulatory agencies understood that community and regional banks did not cause the financial crisis. Accordingly, they should not be subject to the same requirements that are appropriate for large institutions.

Treasury supports the regulators' efforts to tailor their rules for community banks and is committed to implementing the Dodd-Frank Act in a way that builds a more efficient, transparent, and stable financial system that contributes to our country's economic strength, instead of putting it at risk. The Dodd-Frank Act generally authorizes tailored regulation to reflect the size and complexity of banking organizations. The Dodd-Frank Act recognizes that community banks did not cause the financial crisis and was structured to limit their regulatory burdens.

Treasury will continue to work with Congress and the regulators to help make sure that laws are implemented in a way that preserves the important roles of community and regional banks and keeps capital flowing to the customers they serve.

Q.3. In July of 2013, the Treasury Borrowing Advisory Committee reported that new regulations stemming from Basel III and Dodd-Frank will likely result in constrained liquidity in the market. Even well-intentioned rules like the Supplementary Leverage Ratio (SLR) may constrain liquidity in markets as deep and understood as those for U.S. Treasury securities.

What has been done specifically to address concerns regarding market liquidity in anticipation or as a result of new regulations?

Given the views and commentary of the TBAC and other market participants, which rules are worth revisiting?

A.3. Our efforts to reform the financial sector have made the system far safer and more resilient than it was in 2008. There is much less leverage, and the big banks are better capitalized. Moreover, we believe that financial reform will create more effective and better functioning markets throughout business cycles. We know that many factors are having significant effects on financial markets, some of which pre-date the crisis and reflect the evolution of market structure. All of these factors are affecting market behavior, and Treasury is constantly monitoring liquidity in financial mar-

kets—as they continue to evolve—and the degree to which the reforms we put in place are achieving the intended results.

RESPONSES TO WRITTEN QUESTIONS OF CHAIRMAN SHELBY FROM PAUL SCHOTT STEVENS

Q.1. What can be done to improve the determination process including with respect to improving transparency and accountability? Please clarify which of your recommendations warrant congressional action and which recommendations the FSOC would be able to implement on its own pursuant to an existing statutory authority.

A.1. ICI supports U.S. and global efforts to address abuses and excessive risk in the financial system, but we are concerned that the FSOC is seeking to exercise its designation authority quite broadly and to the exclusion of other mandates. The opacity of the designation process only exacerbates this problem.

The FSOC's supplemental procedures to the SIFI designation process, implemented in February, are welcome, but fall well short. These changes should be codified in statute to provide greater certainty and predictability to the process. In addition, Congress must act to require the FSOC to give both primary regulators and companies under consideration for designation an opportunity to address identified systemic risks prior to designation, as well as require an enhanced post-designation review process. Such steps would support the FSOC's mission both by reducing risks in the financial system and by reserving SIFI designations and the exceptional remedies that flow there from only to those circumstances in which they are clearly necessary.

The Institute believes that Title III of the Financial Regulatory Improvement Act of 2015 significantly addresses these concerns. The Institute also supports H.R. 1550, the Financial Stability Oversight Council Improvement Act, which includes similar de-risking provisions, as well as codifies into statute FSOC's supplemental procedures.

In none of its nonbank designations thus far has the FSOC chosen to explain the basis for its decision with any particularity. Instead, it appears to have relied on a single metric (a firm's size) to the exclusion of the other factors cited in the Dodd-Frank Act. It also has theorized about risks instead of conducting the kind of thorough, objective, empirical analysis that should underlie its decisions. The FSOC should be explicit about the systemic risks it identifies arising from a firm's structure or activities, and the results of any analysis that might lead to designation should be made public. This would be beneficial on all sides—it would help market regulators and firms address such risks, and it would promote public understanding of and confidence in what the FSOC regards to be systemically risky and why.

RESPONSES TO WRITTEN QUESTIONS OF CHAIRMAN SHELBY FROM DOUGLAS HOLTZ-EAKIN

Q.1. What can be done to improve the determination process including with respect to improving transparency and accountability?

Please clarify which of your recommendations warrant congressional action and which recommendations the FSOC would be able to implement on its own pursuant to an existing statutory authority.

A.1. There are at least 18 GAO recommendations with an open status that mirror some of the concerns raised in my testimony related to the transparency of FSOC's process.[1] Additionally, past work at the American Action Forum has highlighted many potential reform options to improve transparency and accountability including but not limited to:[2]

- Regular meetings and communication with experts and stakeholders
- More detailed minutes
- Public disclosure of a checklist of findings regarding a firm along the criteria codified in Dodd-Frank
- Final designations decisions available to the public that cite specific activities or subsidiaries of designated firms posing acute threats to America's financial stability
- Comprehensive assessments of the economic costs and benefits of designation

The Dodd-Frank Act granted FSOC broad authority statutorily to set the specific determinants of a SIFI designation for nonbanks and lay out its operational procedures. FSOC has independently shown some willingness to address criticisms related to the processes and procedures it has developed. Specifically, the procedures adopted in February to open up FSOC and improve communication with firms under review were a good first step. FSOC's broad statutory authority should allow it continue these improvements and make the changes recommended in my testimony.

Of the eight primary criticisms I outlined, the supplemental procedures adopted in February related to points 1, 6, and 7, though none fully addressed the issues raised. If FSOC appears unlikely to move forward with further improvements, it may behoove the Committee to consider legislation that at a minimum requires FSOC to conduct its business with greater analytical rigor, puts oversight authority in the hands of existing regulators and not the Federal Reserve Board of Governors, encourages the Council to consider an activity-based approach ahead of institution-by-institution designation, and more clearly outlines and emphasizes the ability to de-risk and exit designation.

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[1] These recommendations are part of four previous GAO reports: GAO-15-51, GAO-13-622, GAO-12-886, and GAO-12-151.

[2] See Satya Thallam, "Considering an Activity-Based Regulatory Approach to FSOC", (September 2014); *http://americanactionforum.org/research/considering-an-activity-based-regulatory-approach-to-fsoc*; Satya Thallam, "Reform Principles for FSOC Designation Process", (November 2014); *http://americanactionforum.org/research/reform-principles-for-fsoc-designation-process*; and Satya Thallam, "Reform Principles for FSOC Designation Process (Cont'd)", (January 2015); *http://americanactionforum.org/solutions/reform-principles-for-fsoc-designation-process-contd.*

RESPONSES TO WRITTEN QUESTIONS OF SENATOR VITTER FROM DOUGLAS HOLTZ-EAKIN

Q.1. Your testimony recommends that the FSOC share its analysis of what makes a company systemic so that the company might have an opportunity to address those risks and reduce its systemic footprint.

If our ultimate policy goal is to reduce systemic risk, would it make sense for the de-designation process to be more clear, more structured, and more robust?

A.1. Yes, absolutely. As outlined in my testimony, FSOC has not given companies the necessary information or opportunity to understand and address the metrics leading to a SIFI label. The internal changes announced in February are additionally not enough to ensure that designated nonbanks have a genuine opportunity to address Council concerns and exit designation. While FSOC's primary mission is to identify activities and practices that generate systemic risks, in practice it has prioritized designation and regulation of institutions. At a minimum, further clarity and analytical rigor are needed to make annual reevaluations of SIFI status more than just check-the-box exercises, to provide a clear path for companies away from designation, and to uphold FSOC's primary mission of identifying and mitigating risks to America's financial stability.

RESPONSES TO WRITTEN QUESTIONS OF CHAIRMAN SHELBY FROM DENNIS M. KELLEHER

Q.1. What can be done to improve the determination process including with respect to improving transparency and accountability? Please clarify which of your recommendations warrant congressional action and which recommendations the FSOC would be able to implement on its own pursuant to an existing statutory authority.

A.1. The Financial Stability Oversight Council was created less than 5 years ago in the Dodd-Frank Wall Street Reform and Consumer Protection Act. It was tasked with a number of very important responsibilities, including identifying, analyzing, and, if appropriate, designating systemically significant nonbank financial institutions. As AIG, GE, Bear Stearns, Lehman Brothers, and so many more nonbank financial risks proved conclusively in the 2008 financial crash, systemically significant nonbank financial institutions can pose grave risks to the American people, the financial system and our economy. Moreover, they can be costly to our taxpayers and Government when, as they did in 2008, they line up with their hands out for bailouts.

Thus, identifying, analyzing and, if appropriate, designating systemically significant nonbank financial institutions are a key part of protecting the American people and our treasury. A great deal of important work has been done in this area by the Stability Council, including very significant recent changes to make the process work even better.

First, it has to be recognized that the Stability Council did a remarkable job in standing up the entire Council in very little time and acting swiftly to implement the law as directed. While doing

that, it has also made great strides in increasing the transparency and accountability of its designation process. The process was previously too opaque, depriving the public as well as potential designees of important information. For example, the Council did not disclose important data such as the number of firms under consideration, which firms were under consideration, and the number of firms FSOC declined to designate. In addition, the Council did not provide sufficient information about the process it follows for designation. However, to its credit, the Stability Council heard those criticisms, including prominently from Better Markets. It engaged in extensive outreach to all stakeholders.

Second, the Stability Council acted on those concerns and recently changed procedures to be more transparent and accountable. Referred to as Supplemental Procedures, the Stability Council released this past February a series of very significant changes to their processes and procedures, which are designed to improve transparency and accountability. Under the new provisions, the Council provides information about the number of firms it considers for designation and provides additional information as to how it conducts designations. Further, the Council also now interacts with firms under consideration and primary regulators much earlier in the process. These changes are indeed significant, showing that the Council is listening carefully to those who comment on its activities, and is responding with meaningful, timely, inclusive action.

Thus, we do not believe that this is the appropriate time to impose changes on the Stability Council, especially not changes mandated by Congress that are written in law that would deprive the Council of essential flexibility to adapt to unseen, unanticipated, new and emerging systemic risks. We believe that now is the time to let the Stability Council implement its new Procedures and to monitor those changes and the Council to determine if they were sufficient and implemented as well as they could be.

We hold this view knowing that not all of the changes recommended by Better Markets and others were adopted and all criticism, merited or not, has not abated. That, however, should not detract from the remarkable and unprecedented way the Stability Council has done its work while also adapting to new information and circumstances. Given that the Stability Council has shown an ability and willingness to listen and change on its own, we believe that it has earned the trust and respect of critics to continue to work to refine its procedures and policies to balance a number of competing interests while fulfilling its incredibly important mission.

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

LETTER SUBMITTED BY THE NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

March 25, 2015

The Honorable Richard Shelby
Chairman
Senate Committee on Banking,
Housing, and Urban Affairs
534 Dirksen Senate Office Building
Washington, D.C. 20510

The Honorable Sherrod Brown
Ranking Member
Senate Committee on Banking,
Housing, and Urban Affairs
534 Dirksen Senate Office Building
Washington, D.C. 20510

Re: Hearing entitled "FSOC Accountability: Nonbank Designations"

Dear Chairman Shelby and Ranking Member Brown:

On behalf of the National Association of Insurance Commissioners (NAIC)[1], thank you for the opportunity to submit this letter for the record regarding the Financial Stability Oversight Council (FSOC) and its nonbank designations process. Our comments are informed not only from the collective experiences of state insurance regulators, but also the work of those of us that currently or previously have represented state insurance regulators on the FSOC since its inception. Since the early days of the debate over the Dodd-Frank Act, the NAIC has long believed that monitoring and mitigating systemic threats to our financial system and economy would require collaboration among regulators through a council, such as FSOC. Indeed, we believed then as we do now that the prospect of the FSOC bringing together regulators from banking, insurance, and market regulation, each with different perspectives and expertise, could provide a robust mechanism for monitoring the financial system for risks. It has long been our view that a group of regulators with diverse experience can do more collectively than any single regulator could do individually, and preserves the healthy independence and checks and balances necessary to avoid an all-powerful regulatory czar.

While we continue to believe in FSOC's underlying objective, now coming up on its 5th year anniversary, it is clear that FSOC's operations and structure are far from perfect, particularly in the arena of nonbank designations. The NAIC appreciates the steps FSOC has taken to enhance transparency with its recent changes to its nonbank designation process and believe it is a good first step. However, it is apparent to us that more needs to be done. We applaud your commitment to Congressional oversight and exploring ways to improve FSOC.

First, after close to five years and three insurance company designations, we are deeply concerned that the FSOC's consideration of the insurance business model and the efficacy of state insurance regulation appears flawed at best, exacerbated by an apparent and consistent disregard of the views of FSOC

[1] Founded in 1871, the NAIC is the U.S. standard-setting and regulatory support organization created and governed by the chief insurance regulators from the 50 states, the District of Columbia and the five U.S. territories. Through the NAIC, state insurance regulators establish standards and best practices, conduct peer review, and coordinate their regulatory oversight. NAIC members, together with the central resources of the NAIC, form the national system of state-based insurance regulation in the U.S.

members who know and regulate the sector best. This is most clearly evidenced by the designation of two insurance companies, Prudential and MetLife, over the objections of both the independent member with insurance expertise and the undersigned state insurance regulator representative, who all identified serious analytical and factual flaws in these designations. At bare minimum, there should be processes in place to give deference to the statutorily identified experts on insurance to ensure that non-insurance experts cannot overrule the insurance experts based on incorrect premises. While the Council technically has three members with insurance expertise, only two are independent from other Council members (the independent member with insurance expertise and the state insurance commissioner) and only one is a voting member (the independent member). By comparison, 5 of the 10 voting members are regulators of banks or their holding companies (CFPB, FDIC, Federal Reserve, OCC, and NCUA), most of whom do not have responsibilities in the nonbank space and are unlikely to be focused on the protection of insurance consumers, the availability of insurance products, or competitive imbalance within insurance markets. It may be worth exploring an alternative structure for nonbank designations that provides equal weight of the votes of those that regulate the banking sector with those FSOC members that regulate other financial sectors.

Second, notwithstanding our disagreement with FSOC's decision to designate Prudential and MetLife, we are even more troubled by the lack of clarity provided to regulators or even the companies themselves on the specific issues of concern that led to these companies' designation. This approach ultimately fails to make the financial system safer from the risks the company poses because regulators and the company have little information on how to address the company's risk to the system. Moreover, FSOC has historically relied on the first determination standard, which merely requires the FSOC to determine that a nonbank financial company's material financial distress "could pose a threat to the financial stability of the United States"[2] rather than the second determination standard, which would require an identification of activities of concern. The reliance on this standard coupled with the failure of FSOC to set forth plausible scenarios as to how the company's failure could have impacts on the financial system as well as a highly deferential "arbitrary and capricious" review by a federal court creates an "impossible burden of proof for companies to meet as it effectively requires [a firm under consideration] to prove that there are no circumstances under which the material financial distress of the company could pose a threat to the financial stability of the United States."[3]

In addition, FSOC has not taken steps to set forth an "exit ramp" for designated firms. While FSOC is statutorily required to review the firms on an annual basis, this annual review process has failed to yield any specific information for regulators or companies as to the nature of risks that would need to be mitigated or the nature of the actions that would have to be taken for a designation to be rescinded. We believe the failure of FSOC to set forth a clear rationale as to the reasons for designation and to provide an "exit ramp" for designated firms is a fundamental flaw with the nonbank designation process that contributes to rather than reduces risks to the financial system. Policymakers should not be lulled into a false sense of security that labelling a firm systemic, applying an additional "SIFI surcharge," and requiring it to file a resolution plan will meaningfully change a firm's risk profile in the absence of further action to reduce or eliminate the threats of concern. If FSOC is unable or unwilling to change its process to address such flaws, we believe it is incumbent on Congress to do so in order to protect financial consumers and the financial system of the United States.

Last, we have deep concerns about the lack of involvement of state insurance regulators in FSOC deliberations. While in recent years FSOC has made efforts to formally consult with state insurance regulators throughout the nonbank designations process as required by the Dodd-Frank Act and FSOC's

[2] Dodd Frank Act §113
[3] View of Adam Hamm, the State Insurance Commissioner Representative, on the Designation of MetLife, Inc. at 6.

own Nonbank Designations Rule and Guidance, the typical one-off nature of such consultations remains troubling. In fact, FSOC has not yet even signed Memoranda of Understanding with all the state insurance departments. Unlike our federal counterparts, insurance is primarily regulated by 56 states and jurisdictions that work together through the NAIC. Though the Chair of a federal agency that sits on FSOC could apprise agency staff of issues discussed at FSOC that may impact the sector they regulate, prohibitions placed on FSOC members have prevented our representatives from discussing issues with us that could impact the insurance sector. It would also stand to reason that to the extent FSOC identifies systemic risk concerns that emanate from the insurance sector, FSOC would want to apprise regulators of such concerns so we could use our authorities to address them. The fact that FSOC has not yet set up robust processes to do so is a critical flaw in FSOC's operations and potentially puts the insurance sector at risk.

Thank you once again for the opportunity to provide these comments to the Committee for its consideration. We appreciate your continued robust oversight over the FSOC and look forward to working with you as the Committee considers potential changes to its structure and operations.

Sincerely,

Monica Lindeen
NAIC President
Montana Commissioner of
Securities and Insurance

John M. Huff
NAIC President-Elect
Former Member, FSOC
Director of Missouri's Department of Insurance,
Financial Institutions, and Professional Registration

Sharon P. Clark
NAIC Vice President
Kentucky Insurance Commissioner

Theodore K. Nickel
NAIC Secretary-Treasurer
Wisconsin Insurance Commissioner

Adam Hamm
NAIC Past-Present
FSOC Member
North Dakota Insurance Commissioner

E. Benjamin Nelson
NAIC Chief Executive Officer

STATEMENT SUBMITTED BY PETER J. WALLISON, ARTHUR F. BURNS FELLOW IN FINANCIAL POLICY STUDIES AT THE AMERICAN ENTERPRISE INSTITUTE

Statement submitted to the United States Senate Committee on Banking, Housing, and Urban Affairs

On FSOC Accountability: Nonbank Designations

Transparency on FSOC Designations and its Relations with the FSB

Peter J. Wallison

Arthur F. Burns Fellow in Financial Policy Studies

American Enterprise Institute

March 25, 2015

The views expressed in this testimony are those of the author alone and do not necessarily represent those of the American Enterprise Institute.

March 25, 2015

Chairman Shelby, Ranking Member Brown and members of the Senate Banking Committee:

Thank you for the opportunity to submit written testimony for this hearing.

My name is Peter J. Wallison. I am the Arthur F. Burns Fellow in Financial Policy Studies at the American Enterprise Institute. The opinions expressed below are mine alone and not necessarily those of the American Enterprise Institute.

The invitation for this hearing made clear that it is to be focused on transparency at FSOC, particularly transparency in the process of designating nonbank financial firms as systemically important financial institutions (SIFIs). In submitting this testimony, I want to challenge more than simply the transparency of the designation process; I want to challenge whether some nonbank firms have been properly designated as SIFIs, as well as the transparency of the FSOC's relationship with the Financial Stability Board (FSB). The FSB, as this committee is aware, is a largely European group of financial regulators and central banks of which the Treasury, the Federal Reserve and the SEC are members. I do not believe the FSOC has made clear the degree to which the decisions of the FSB were influential in the FSOC's designation of SIFIs or will be influential in the efforts of the FSOC and the Fed in the future to subject what the FSB calls "the shadow banking system" to prudential regulation.

General comment on SIFI designations

Before proceeding with a discussion of the FSOC and the FSB, I should note that I do not believe that any nonbank financial institution, no matter how large, can legitimately be designated as a systemically important financial institution (SIFI) in the United States. The provisions of the Dodd-Frank Act that authorize FSOC to designate SIFIs are based on the supposition that *interconnections* among large nonbank firms make them vulnerable to failure if one of them fails. This, in turn, will create instability in the US financial system.

Yet, when Lehman Brothers was allowed to fail in 2008 there was no evidence that the firm's interconnections caused significant losses to others. Lehman was a $650 billion firm—one of the largest in the US financial system—and a major participant in the credit default swap markets. Even though the firm filed for bankruptcy suddenly and unexpectedly at a time of great market anxiety about the health of financial institutions, no other large financial institutions failed or became unstable as a result of its exposure to Lehman. That demonstrates—I think without question—that concern about "interconnections" among large financial institutions is misplaced. While interconnections of some kind certainly exist among financial firms, the exposures

involved are simply not large enough to cause the insolvency of other large nonbank financial institutions when one of them fails.

To be sure, chaos followed Lehman's bankruptcy. However, this was because the government had suddenly and unexpectedly reversed the policy of rescuing large firms that it had established in March 2008 with the rescue of Bear Stearns. Market expectations, as a result of this reversal, were completely upended. That caused some losses—most notably at the Reserve Fund, which probably anticipated it would be bailed out with a government rescue of Lehman—but even that money market fund only suffered losses of one or two percent. The purpose of SIFI designations should not be to prevent business failures, or losses to others when businesses fail, but only conditions in which business failures will bring down major portions of the US economy. As Lehman demonstrated, that does not happen even with the failure of a very large nonbank firm.

Accordingly, because the authority of the FSOC to designate nonbank financial institutions is unnecessary (and actually harmful to competition in the financial industry), it should be repealed.

The FSB's influence on SIFI designations

The way the FSOC has exercised its designation authority is also a reason for repeal of this authority. When Congress authorized the FSOC to designate large nonbank financial firms as SIFIs, it assumed that the FSOC would follow a fair, objective, and fact-based process in exercising that authority. Although officials have asserted that the FSOC's designation decisions have been the result of such a process, that is not supported by the facts.

The Treasury and the Federal Reserve Board are unquestionably the most important and influential members of the FSOC—the Treasury because the secretary of the Treasury is the chair of the FSOC and the Fed because it is by far the most powerful US financial regulator. Both the Treasury and the Fed are also members of the FSB, and it is reasonable to assume, given the importance of the US financial system, that the Treasury and the Fed are the most important and influential members of the FSB.

In 2009, the FSB was deputized by the G-20 leaders, including, of course, President Obama, to reform the international financial system. After receiving this mandate, the FSB determined to proceed by designating certain firms as "global SIFIs," and on July 18, 2013, it designated nine large international insurers—including three large US insurers, AIG, Prudential and MetLife—as global systemically important insurers, or G-SIIs.[1] The FSOC had designated AIG as a SIFI

[1] FSB, "Global systemically important insurers (G-SIIs) and the policy measures that will apply to them" July 18, 2013, http://www.financialstabilityboard.org/wp-content/uploads/r_130718.pdf?page_moved=1.

before the FSB had made its designations, but Prudential was not designated as a SIFI until September 2013 and MetLife not until December 2014.[2]

The designation of SIFIs is what is called a quasi-judicial proceeding, where evidence is weighed against a statutory standard of some kind and an administrative agency applies the standard to a single party, as a court—based on evidence—would apply the law to a single defendant. Quasi-judicial proceedings are usually expected to meet certain standards of fairness and objectivity.

In testimony last week before the House Financial Services Committee, Treasury Secretary Lew stated that the FSB "acts by consensus." A consensus literally means an agreement; synonyms of consensus in most dictionaries are concurrence, harmony, accord, unity and unanimity. So when these three firms were designated by the FSB as G-SIIs the Treasury and the Fed necessarily concurred in the decision.

This means that months *before* the FSOC designated Prudential or MetLife as SIFIs the Treasury and the Fed—the two most important members of the FSOC—had already determined as members of the FSB to designate Prudential and MetLife as G-SIIs. Obviously, if a firm is a G-SII on a global scale, it is going to be a SIFI in its home country. Thus, whatever process the FSOC might have followed in the designation of Prudential and MetLife, it could not be considered fair, objective and evidence-based if the chairman of the FSOC and the Fed—as members of the FSB—had already decided the issue months before.

Moreover, the FSB has not explained the basis for its designations of Prudential and MetLife, except to say that they were made in conformity with a methodology of the International Association of Insurance Supervisors. Although the methodology was made public, the FSB has never explained how the methodology applied to any of the insurers, including the three US insurers. So the need for an objective evidence-based decision-making process could not be cured in any way by whatever process the FSB may have followed in making its designations.

Clearly, then, the FSOC's tainted designations of Prudential and MetLife cannot be considered the kind of deliberative process that was sanctioned by Congress when it authorized the FSOC to make SIFI designations.

In addition, there is evidence that the Treasury and the Fed believe they are bound by the decisions at the FSB, possibly including designation decisions. In early February, 2015, the chairman of the FSB, Mark Carney, sent a memorandum to FSB members, notifying them that the FSB considered them to be bound by its decisions. Because of the importance of the US as a member of the FSB, it is highly unlikely that the chairman would have sent this memorandum without the agreement of the Treasury and the Fed.

The memorandum noted that the FSB expects "full, consistent and prompt implementation of [its] agreed reforms."[3] When questioned about this by Chairman Jeb Hensarling at the HFSC

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[2] FSOC, US Department of the Treasury, Designations, Feb. 4, 2015, http://www.treasury.gov/initiatives/fsoc/designations/Pages/default.aspx.

[3] Mark Carney, Memorandum to G20 Finance Ministers and Central Bank Governors, February 4, 2015, http://www.financialstabilityboard.org/wp-content/uploads/FSB-Chair-letter-to-G20-February-2015.pdf.

hearing last week, Treasury Secretary Lew denied that the US was bound by these "agreed reforms." Hensarling pointed out that the FSB had recently "exempted" three Chinese banks from the reforms and asked "if these are preliminary suggestions and not rules [by the FSB] why is it that the FSB found it necessary to grant exemptions, specifically to the Chinese?" Secretary Lew had no answer to this question at the hearing.

If in fact the FSOC, the Treasury and the Fed believe they are bound by FSB decisions, there is a further reason for seeing the FSOC's designation of Prudential and MetLife as illegitimate. The designation decision was in effect made by the FSB and not the FSOC.

Do the FSOC and other US agencies have authority to implement FSB directives?

Finally, another troubling matter came to light in the course of last week's HFSC hearing. In answering the same question by chairman Hensarling, Secretary Lew stated that "what the FSB does is it raises global—the goal for global standards to a high level…We work in the FSB to try to get the kinds of standards that we think are appropriate in the United States to be adopted around the world so that the whole world will have high standards."

The first thing to note about this statement is that it validates Chairman Hensarling's concern that the FSB, as well as the Treasury and Fed, are treating the FSB's decisions as binding on the FSB members. Obviously, if the US is trying to raise global standards through the FSB, it would be essential to have those standards viewed as mandatory rather than optional. This explains why the FSB gave an "exemption" to the Chinese banks; that wouldn't have been necessary, as Chairman Hensarling suggested, if the FSB's rules were not binding on China.

Secretary Lew's statement also raises troubling questions about what the FSOC, the Treasury and the Fed believe about their authority to implement the ideas and policies adopted by the FSB. If, as the Secretary avers, the US is using the FSB as a mechanism for raising "global standards" to a level that "we think are appropriate in the United States," this must mean that the Treasury and the Fed believe they have the authority to do in the United States what they are attempting to get the FSB to prescribe for all other FSB members.

This is the nub of the issue. In a policy paper dated August 29, 2013, the FSB said that in order to control and regulate what it calls the "shadow banking system" it is necessary to regulate "complex chains of transactions." These, in the FSB's view can create systemic risks even though pursued by entities that are not themselves systemic in size. Thus, the FSB continued, "[E]xperience from the crisis demonstrates the capacity for some non-bank entities and transactions to operate on a large scale in ways that create bank-like risks to financial stability." [4] The scope of this concept is startling. The capital markets function through chains of transactions—dividing up risks, distributing credit, buying and selling interests in securities or other credit instruments—so seeking to regulate complex chains of transactions among firms in the capital markets is tantamount to placing the entire capital market system under prudential regulation.

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[4] FSB, "Strengthening Oversight and Regulation of Shadow Banking" August 29, 2013, pii. http://www.financialstabilityboard.org/wp-content/uploads/r_130829c.pdf?page_moved=1.

This idea has already been adopted by the FSOC, while using a slightly different form of words. In its December 18, 2014 Notice on Asset Management Products and Activities, the FSOC stated: "risks to financial stability might not flow from the actions of any one entity, but could arise collectively across market participants." [5] The concept seems identical to a "complex chain of transactions."

Although the Dodd-Frank Act provides authority for regulating *entities* that are deemed to be systemically important, it is difficult to find any statutory authority in Dodd Frank or any other financial regulatory system in the US for regulating "complex chains of transactions" or "risks…that arise collectively across market participants." Yet, by concurring with—if not actually sponsoring—the FSB's idea that complex chains of transactions should be regulated in order to control the dangers of shadow banking, it is apparent that the Treasury and the Fed believe that they would have the power to regulate those transactions when the directive from the FSB instructs them to do so.

The question that falls out of this analysis is simply this: where did the Treasury and Fed acquire the power to regulate a *complex chain of transactions* for the purpose of controlling what they call shadow banking?

This committee should seek the answer to that question. It would be troubling if US agencies believe their authority to follow the FSB's directives flows from the G-20's deputization of the FSB. That would mean that the US president can create regulatory authority in the US through an agreement with the leaders of other nations, and would call into question the unique authority of Congress under the US constitution to make the laws applicable in the United States.

Conclusion

Accordingly, while I certainly support the idea that additional transparency is necessary at the FSOC, the first and most important issue is transparency about three preliminary questions: (i) the nature of the FSOC's relationship with the FSB; (ii) whether the FSOC, the Treasury and the Fed believe they have the authority to regulate complex chains of transactions in the US; and (iii) if they believe they have such authority, where they acquired it.

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[5] Financial Stability Oversight Council, Notice Seeking Comment on Asset Management Products and Activities (Dec. 18, 2014), p4 available at http://www.treasury.gov/initiatives/fsoc/rulemaking/Documents/Notice%20Seeking%20Comment%20on%20Asset%20Management%20Products%20and%20Activities.pdf. See, also, Michael S. Piwowar, "Remarks at the 2015 Mutual Funds and Investment Management Conference, March 16, 2015, p4

STATEMENT SUBMITTED BY AARON KLEIN, DIRECTOR OF THE BIPARTISAN POLICY CENTER'S FINANCIAL REGULATORY REFORM INITIATIVE

BIPARTISAN POLICY CENTER

Statement by Aaron Klein, Director of the Bipartisan Policy Center's Financial Regulatory Reform Initiative

"FSOC Accountability: Nonbank Designations"

Committee on Banking, Housing, and Urban Affairs
U.S. Senate
March 25, 2015

The Bipartisan Policy Center's (BPC) Financial Regulatory Reform Initiative (FRRI) was launched in 2012 to assess the Dodd-Frank Act: what is working, what is not working, and how financial regulation and supervision can be improved. Over the last three years, the performance of the Financial Stability Oversight Council (FSOC) has been a key area of our research and focus.

As part of this effort, BPC recently analyzed and summarized 56 recommendations by stakeholders with a range of perspectives on ways to improve the FSOC. The proposals included ideas to enhance transparency and communications with the public, improve the "systemically important financial institution", or SIFI, designation process, strengthen communications with market participants and further develop the "de-designation process" for nonbank firms already designated by FSOC as SIFIs. (A copy of this FSOC Reform Overview is attached as an addendum to this testimony.)

In an effort to improve its processes, FSOC recently solicited reform ideas from outside stakeholders, including BPC. In January, the Council adopted a series of measures designed to improve transparency, strengthen communications, and enhance its designation and de-designation processes. These reforms are important steps in the right direction and FSOC should be applauded for taking them. Despite these initial, incremental steps, FSOC still has a long way to go in order to address legitimate concerns regarding its opaque processes, to improve its communication with companies under consideration for SIFI designation and those already designated, and to create a robust and implementable de-designation process. If it is to fulfill its core

missions of improving regulatory coordination and mitigating risks to the financial system, FSOC must continue to evolve.

Let me turn to two specific areas where there is room for improvement — public transparency and SIFI de-designation —while noting that BPC research has recommended several other reform measures that FSOC should adopt to improve its operations.[1]

Enhancing Public Transparency

FSOC has struggled to find the proper level of transparency with both the public and the nonbank companies under consideration for designation as SIFIs. In particular, FSOC has been wary of communicating with the public in real time. At first, minutes from FSOC meetings were essentially lists of attendees and broad topics of conversation with no real insight into what was discussed. Topics the Council would have likely discussed due to their potential impact on financial stability, such as the potential systemic consequences from a possible default on Puerto Rican debt, were simply not mentioned in the minutes. This stands in sharp contrast to the minutes published by the Federal Reserve's Federal Open Markets Committee (FOMC), which releases detailed insights into its conversations on issues that can have similar market-moving implications. The BPC recommended in April 2014 that FSOC improve the quality of its minutes, using the FOMC as a model.[2]

In May 2014, FSOC, to its credit, committed to release more detailed minutes. While the minutes have improved in quality since then, they remain inadequate and insufficient. For example, at January's FSOC meeting, the only mention of the financial stability impact of the sharp decline in the price of oil which had just occurred is at the end of a sentence summarizing concerns relating to leveraged lending and speculative-grade debt. It stated:

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[1] John Dugan, Peter Fisher and Cantwell Muckenfuss III. *Responding to Systemic Risk: Restoring the Balance.* Bipartisan Policy Center. September 2014. 38-53. http://bipartisanpolicy.org/wp-content/uploads/sites/default/files/BPC%20Responding%20to%20Systemic%20Risk.pdf.

[2] Richard Neiman and Mark Olson. *Dodd-Frank's Missed Opportunity: A Road Map for a More Effective Regulatory Architecture.* Bipartisan Policy Center. April 2014. 42. http://bipartisanpolicy.org/wp-content/uploads/sites/default/files/BPC%20Dodd-Frank%20Missed%20Opportunity.pdf.

"Members of the Council then asked questions on topics including implications of the decline in oil prices, and had a discussion."[3]

It is not clear what views, if any, were expressed by any of the members of the Council on the subject at hand. All we know is that there was a discussion, with no insight into what actually was discussed.

In stark contrast, the FOMC's January minutes devote an entire paragraph to specific staff reports on potential risks to financial stability with a detailed discussion that included a cogent analysis on the effect of the decline in oil prices on financial stability: "The effects on the largest banking firms of the sharp decline in oil prices and developments in foreign exchange markets appeared limited, although other institutions with more concentrated exposures could face strains if oil prices remain at current levels for a prolonged period."[4]

FSOC should take two further simple steps to improve the quality of its minutes:

First, instead of identifying a regulator but not the substance of his or her comments in its minutes, the Council should do the reverse, instead adopt the FOMC's "Chatham House Rules" approach to recording the minutes of its meetings. The minutes should convey substance of conversation but not identify the individual speakers who made specific remarks.

Second, FSOC should prepare detailed, substantive minutes, and then only allow member agencies to edit portions that are substantively inaccurate or would reveal sensitive or proprietary information. In other words, the Council needs to produce detailed minutes and set a higher bar to redact information in order to avoid the minutes

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[3] "Minutes of the Financial Stability Oversight Council." Financial Stability Oversight Council. January 21, 2015. http://www.treasury.gov/initiatives/fsoc/council-meetings/Documents/January%2021,%202015-Minutes.pdf.

[4] Thomas Laubach. "Minutes of the Federal Open Market Committee." Board of Governors of the Federal Reserve System. January 27-28, 2015. http://www.federalreserve.gov/monetarypolicy/fomcminutes20150128.htm.

devolving into the "lowest common denominator" of agreement among the ten voting members.

More broadly, FSOC should also improve its communication with outside stakeholders. Late last year, the Council engaged with stakeholders, including BPC, on ways to improve the SIFI designation and de-designation processes – an outreach effort that resulted in many of the positive steps described above. However, it remains to be seen whether this outreach was a one-time endeavor, or whether FSOC will engage in semi-regular outreach or even establish a formal and regular pattern of engagement with a wide variety of outside stakeholders. We urge FSOC to build on its recent progress and formalize its stakeholder outreach efforts.

Developing a More Formal De-Designation Process

Once a nonbank firm has been designated as a SIFI, Dodd-Frank envisions a process by which a firm may be de-designated if it no longer poses a significant threat to financial stability. Because the SIFI framework is new and the designation process has generally been lengthy, we have yet to see a firm be de-designated. This is not troubling. What would be troubling is if no real process emerges that would ever realistically allow for a de-designation to occur. It is also not clear whether there is full commitment by FSOC and all of its members to the intent of Congress that de-designation be an important and necessary component to the new systemically focused regulatory framework.

BPC was pleased that FSOC highlighted the question of how to look at de-designation during its recent engagement with stakeholders. FSOC said that the changes it adopted earlier this year would "create a clearer and more robust process for the Council's annual reviews of its designations."[5] This is another step in the right direction. However, many details as to how exactly this will occur remain unanswered:

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[5] "Financial Stability Oversight Council Announces Changes to Nonbank Designations Process," Financial Stability Oversight Council, press release, February 4, 2015, on the U.S. Department of the Treasury website, http://www.treasury.gov/press-center/press-releases/Pages/jl9766.aspx, accessed March 23, 2015.

- What are the metrics by which FSOC will review a SIFI's designation?
- How much detail and clarity will be given to companies as to why they were designated?
- Will the same FSOC staff that recommended designation be responsible for annual reviews?
- What will be the role of the Federal Reserve, which through designation became each SIFI's primary regulator where it was not prior to designation?
- Is conducting annual reviews the most appropriate time frame, and should each review be conducted the same way?
- Is the current system, that a firm is designated as a SIFI in perpetuity and can only lose that status via de-designation, the right framework or should SIFI designations be sunset to force a more thorough review?
- Is de-designation something a SIFI can reasonably expect to achieve if it sufficiently reduces its systemic risk, or is it a "Hotel California," pro forma process with no viable exit?

BPC is actively engaged in research attempting to answer these and related questions. We hope to publish our recommendations later this year. We believe that this is an important issue and hope that FSOC remains committed to producing additional work, including making clear to the public what metrics are involved in the de-designation process. It also may yield additional benefits. One way FSOC could clarify how the *designation* process works is by clarifying how the *de-designation* process works.

CONCLUSION:

When BPC began its work three years ago, we wrote that the creation of FSOC "has the potential to be the crown jewel of Dodd-Frank."[6] We still think it can be. Yet, FSOC is still very much a work in progress with significant room to improve its processes, communication,

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[6] Dr. Martin Neil Baily, Dr. Phillip Swagel and Aaron Klein. *Promoting Financial Stability and Economic Growth: An Introduction to the Bipartisan Policy Center's Financial Regulatory Reform Initiative*. Bipartisan Policy Center, October 2012. Available at: http://bipartisanpolicy.org/wp-content/uploads/sites/default/files/FRRI%20White%20Paper.pdf.

transparency, and operations. We urge the Council and Congress to carefully consider these recommendations as well as many of the other thoughtful reform measures proposed by other stakeholders. If we can improve transparency, accountability, and efficacy of this important institution, we can help FSOC live up to its potential – and enable this "crown jewel" of Dodd-Frank to shine.

REPORT SUBMITTED BY THE BIPARTISAN POLICY CENTER

Bipartisan Policy Center

FSOC REFORM:
AN OVERVIEW OF RECENT PROPOSALS

BIPARTISAN POLICY CENTER

Nearly five years ago, the Dodd-Frank Act established the Financial Stability Oversight Council (FSOC) to provide a forum for the nation's financial regulators to identify and respond to threats to financial stability and to promote regulatory cooperation. In recent years, however, FSOC has faced a growing barrage of criticism, along with a flurry of ideas that have been held out as improvements. Policymakers on both the left and right have proposed strengthening FSOC's transparency and communication, reforming its process for designating large and complex nonbank financial institutions as systemically important financial institutions (SIFIs), and even altering its membership and structure.

FSOC has taken notice. Last October, Treasury Secretary Jacob J. Lew, who also serves as FSOC's chairman, said that FSOC was "committed to improving its effectiveness and engaging with the public ... [and would] consider possible changes to its [designations] process." FSOC staff followed up with a series of panel discussions and actively solicited reform ideas from a wide array of stakeholders, including the Bipartisan Policy Center (BPC). FSOC staff is expected to report back to the full council soon with recommendations.

BPC's Financial Regulatory Reform Initiative (FRRI) has followed these developments closely. Over the last few months, FRRI analyzed a series of FSOC reform proposals offered by members of Congress, the Government Accountability Office, financial reform advocates, financial industry groups, and other financial policy experts. Ideas came in the form of comment letters, articles, speeches, and reports. FRRI also reviewed legislative proposals, including five bills introduced in the U.S. House during the 113th Congress.

This analysis provides an overview of major FSOC reform ideas. This is not a BPC endorsement of any specific proposal beyond FRRI's own recommendations, and is not intended to capture every FSOC reform idea ever proposed. Instead, BPC hopes that this document can serve as a useful tool for policymakers, lawmakers, and other analysts to consider, compare, and develop ideas to make FSOC work better.

FSOC REFORM: AN OVERVIEW OF RECENT PROPOSALS

PART I. IMPROVING TRANSPARENCY AND COMMUNICATIONS

ISSUE 1: FSOC has not been transparent enough with companies under evaluation about their status in the SIFI designation process or about what information is being reviewed. FSOC should communicate with those companies more frequently and in greater detail about the process.

Improve transparency with companies under evaluation for designation: FSOC should:

- Allow companies being evaluated for designation to provide information and comment on the accuracy of data being used by FSOC in its evaluations;
- Inform companies when the designation process reaches a new stage of inquiry; and
- Let companies under consideration for designation engage in dialogue with all FSOC members.

Bipartisan Policy Center, "Responding to Systemic Risk: Restoring the Balance," September 2014

Improve data and communication for "Stage 2" reviews of the SIFI designation process: FSOC should:

- Notify companies of the data being used by FSOC in considering a company for designation and update the disclosure at least every 90 days;
- Request data directly from companies if the data FSOC has are insufficient to fully evaluate a company for the "Stage 2" process;
- Accept and distribute to all member agencies any data submitted by companies under consideration;
- Ensure members and member agency staff are allowed to speak with each company about data that has been collected; and
- Notify companies that are being considered for possible designation that FSOC is collecting data for that purpose. That notice should be delivered at least 270 days before providing written notice that FSOC has moved the company to a "Stage 3" analysis.

SIFMA et al., "Petition for Financial Stability Oversight Council Rulemaking Regarding the Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies," August 2014[1]

Provide greater detail and due process at multiple stages: FSOC's written notice of proposed designation and written notice of final designation of a company should include detailed assessments, tied to statutory considerations, of how the company could threaten financial stability, how prudential standards resulting from designation will mitigate those threats, and what information is reasonably necessary for the company to evaluate and contest designation (in the case of a proposed designation) or remove the threat(s) to financial stability (in the case of a final designation). Further, FSOC should give companies the right to present oral argument and testimony at an evidentiary hearing, and it should enable companies to review and correct the evidentiary record, at least 25 days prior to that hearing.

SIFMA et al., "Petition for Financial Stability Oversight Council Rulemaking Regarding the Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies," August 2014

[1]The joint petition was signed by the American Council of Life Insurers (ACLI), the American Financial Services Association (AFSA), the Association of Institutional INVESTORS (AII), the Financial Services Roundtable (FSR), and the Asset Management Group of the Securities Industry and Financial Markets Association (SIFMA).

FSOC REFORM: AN OVERVIEW OF RECENT PROPOSALS

Expand outreach during initial SIFI designation review: Prior to a "Stage 2" comprehensive review of a company, FSOC must provide written notice outlining a specific basis for the review. FSOC must also grant the institution the opportunity to submit written materials as part of the evaluation.

Financial Stability Oversight Improvement Act of 2014 (H.R. 5180), Ross (R-FL) and Delaney (D-MD)

Notify companies that are no longer being considered for designation: FSOC should notify each company that is no longer being considered for designation, including a statement asserting that FSOC will notify the company if and when it is being considered again.

SIFMA et al., "Petition for Financial Stability Oversight Council Rulemaking Regarding the Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies," August 2014

FSOC REFORM: AN OVERVIEW OF RECENT PROPOSALS

PART I. IMPROVING TRANSPARENCY AND COMMUNICATIONS

ISSUE 2: FSOC's process and reasoning for its decisions are not sufficiently transparent or public, making its actions difficult to evaluate. FSOC should improve its public transparency while protecting confidential regulatory and supervisory information.

Release FOMC-style minutes: FSOC should publicly release detailed minutes of its closed-door meetings along the lines of the Federal Reserve's Federal Open Market Committee (FOMC), which releases its minutes three weeks after each meeting.

Bipartisan Policy Center, "Dodd-Frank's Missed Opportunity: A Road Map for a More Effective Regulatory Architecture," April 2014

Publish detailed minutes of most closed-door FSOC meetings: FSOC should keep detailed records of closed-door sessions of principals' meetings and, when possible, make them public—after enough time has passed to avoid the release of information that is market-sensitive or would limit deliberations.

Government Accountability Office, "New Council and Research Office Should Strengthen Accountability and Transparency of Decisions," September 2012

Improve public transparency: FSOC should consider releasing transcripts of closed-door meetings after a suitable time period has passed and/or appropriate redactions have been made. FSOC should also review its list of the types of information that trigger the closing of council meetings, as some are overly broad.

Americans for Financial Reform, "Background on the Financial Stability Oversight Council," June 2014

Improve transparency of meetings: FSOC should hold open meetings, or release minutes of meetings and policy discussions, when disclosure would not compromise private and proprietary information. This includes SIFI-designation discussions of how an individual company's failure could destabilize financial markets.

American Action Forum, "Reform Principles for FSOC Designation Process," November 2014

Improve transparency and disclosure through existing legislative measures: FSOC would be subject to the Government in the Sunshine Act and the Federal Advisory Committee Act, which govern the transparency of agency business, including requirements for open meetings and reporting.

FSOC Transparency and Accountability Act (H.R. 4387), Garrett (R-NJ)

Publicly release most final reports or studies: FSOC must make publicly available any final report, study, or analysis it has prepared—unless it is specifically exempt from disclosure.

Financial Stability Oversight Improvement Act of 2014 (H.R. 5180), Ross (R-FL) and Delaney (D-MD)

Develop a public communication strategy: FSOC should improve its communication with the public by, for example, improving its web presence and regularizing key notices and other communications.

Government Accountability Office, "New Council and Research Office Should Strengthen Accountability and Transparency of Decisions," September 2012

FSOC REFORM: AN OVERVIEW OF RECENT PROPOSALS

Strengthen the protection of confidential information: FSOC should ensure confidentiality of the names of companies discussed in closed-door council meetings and of proprietary information used in the SIFI designation process.

U.S. Chamber of Commerce, "Financial Stability Oversight Council Reform Agenda," August 2013

Meet regularly with outside experts: FSOC should prioritize meeting with outside experts to gather a wider range of input.

American Action Forum, "Reform Principles for FSOC Designation Process (Cont'd)," January 2015

FSOC REFORM: AN OVERVIEW OF RECENT PROPOSALS

PART I. IMPROVING TRANSPARENCY AND COMMUNICATIONS

ISSUE 3: FSOC does not give companies sufficient details about why they are being considered for SIFI designation or are already designated as SIFIs. FSOC should give such companies reasonable opportunities to correct information being evaluated and to contest specific allegations of the risks they pose to financial stability.

Add detail to "Stage 3" review notice for proposed designation: When FSOC provides notice to a company that it is being considered for designation in "Stage 3," it should include the factual basis for the council's decision and an analysis of each statutory consideration for how the company threatens financial stability.

SIFMA et al., "Petition for Financial Stability Oversight Council Rulemaking Regarding the Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies," August 2014

Add detail to explanations of designations: FSOC should provide more detail on why future SIFI designees meet one or both of the statutory designation standards set forth in Dodd-Frank. If FSOC concludes that a company does not meet one of the two standards, it should evaluate the company under the second standard as well or provide reasons why the second standard is not relevant.

Government Accountability Office, "Further Actions Could Improve the Nonbank Designation Process," November 2014

PART II. REFORMING THE "SIFI" DESIGNATION PROCESS

ISSUE 4: FSOC designates large financial institutions as SIFIs before exhausting alternative ways to mitigate risks to financial stability that may be more effective and less costly. SIFI designation should be the policy option of last resort.

Evaluate alternatives to designation and allow the primary regulator and company the opportunity to mitigate risk and avoid designation: Prior to proposing designation, FSOC must:

- Pass a resolution that identifies the specific risks to financial stability that a company could pose and then give the company's primary regulator at least 180 days—which the primary regulator can waive—to take action to mitigate those risks prior to a proposed determination;
- Consider whether imposing prudential standards via designation is the most appropriate means of mitigating risks to U.S. financial stability; and
- Establish an opportunity for a company to show it can mitigate risk.

If FSOC moves ahead with a proposed determination, it must then provide written notice to the company under review, allow the company to submit written materials for consideration, and provide written notice when FSOC deems its evidentiary record to be complete. If a proposed determination is not made within 180 days of completion of the evidentiary record, FSOC must restart this process with a new resolution. FSOC must give the company in question the opportunity to present a risk mitigation plan in order to avoid designation. The council can approve the risk mitigation plan by a two-thirds vote (including the FSOC chair) and may rescind its approval of the plan by a similar action. Risk mitigation plans must be implemented within a year, but FSOC can grant extensions. A proposed determination must provide a detailed assessment of risks to financial stability and why FSOC rejected the company's plan, including an explanation of why those risks would not be sufficiently mitigated by actions proposed or taken by the company's primary regulator.

Financial Stability Oversight Improvement Act of 2014 (H.R. 5180), Ross (R-FL) and Delaney (D-MD)

Encourage risk mitigation measures: Where possible, FSOC should give companies an opportunity to avoid designation if they can remediate problems that threaten financial stability.

American Action Forum, "Reform Principles for FSOC Designation Process," November 2014

Primary regulator certification of risk mitigation measures: FSOC should give the primary regulator of the company and/or its material subsidiaries an opportunity to certify that its regulatory regime adequately addresses any threats to financial stability from the company that the council has identified.

SIFMA et al., "Petition for Financial Stability Oversight Council Rulemaking Regarding the Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies," August 2014

Give more deference to primary regulators in the SIFI designation process: If a company's primary regulator—or independent FSOC member if the vote is on an insurance company—does not vote in favor of designation, the primary regulator or independent member should issue a report within 30 days explaining its decision. A second vote on whether to designate the company would be scheduled to occur within 45 days of the original designation vote.

U.S. Chamber of Commerce, "Financial Stability Oversight Council Reform Agenda," August 2013

FSOC REFORM: AN OVERVIEW OF RECENT PROPOSALS

PART II. REFORMING THE "SIFI" DESIGNATION PROCESS

ISSUE 5: FSOC's process for SIFI designation and the criteria it uses to make designation decisions are unclear and too informal. FSOC should add detail and clarity and make its changes publicly known.

Clarify the SIFI designation process and policies: FSOC should clarify its processes and criteria for designation and other decisions, specifically:

- Prior to considering any specific company, inform the company of what behaviors FSOC considers systemically risky and what the consequences of designation will be, and give the company a chance to make changes to avoid designation;
- Prior to designation, prove both that a company poses a threat to financial stability and that designation is the only effective remedy;
- Annually evaluate the consequences of designation to a company to ensure that designation and enhanced prudential standards continue to be appropriate;
- Make the metrics used to trigger "Stage 2" consideration more explicit and clear; and
- Consider only companies "predominantly engaged in financial activities" when making further SIFI determinations.

U.S. Chamber of Commerce, "Financial Stability Oversight Council Reform Agenda," August 2013

Clarify internal communications: FSOC should document and publicly disclose its practices on when companies in "Stage 3" evaluations can interact with council members or deputies.

Government Accountability Office, "Further Actions Could Improve the Nonbank Designation Process," November 2014

Fill gaps in "Stage 1" preliminary data collection: FSOC should develop a process to collect the information it needs for "Stage 1" analysis from certain nonbank financial companies—for example, by having the Office of Financial Research collect it when FSOC cannot otherwise get it from public or regulatory sources.

Government Accountability Office, "Further Actions Could Improve the Nonbank Designation Process," November 2014

Monitor the designation process better: FSOC should record the dates of and staff involved with key process steps to aid in evaluating the designation process.

Government Accountability Office, "Further Actions Could Improve the Nonbank Designation Process," November 2014

Mandate compliance with rulemaking processes: FSOC must comply with the Administrative Procedure Act, which sets forth processes for rulemaking that most federal agencies must follow.

Financial Stability Oversight Improvement Act of 2014 (H.R. 5180), Ross (R-FL) and Delaney (D-MD)

FSOC REFORM: AN OVERVIEW OF RECENT PROPOSALS

Provide a 90-day decision-making requirement: Within 90 days of a hearing to contest a proposed determination, which includes an opportunity to present a plan to mitigate the risk(s) detailed in the proposed determination, FSOC must notify the institution under review whether it has decided to designate the company, approve its mitigation plan, or take no further action.

Financial Stability Oversight Improvement Act of 2014 (H.R. 5180), Ross (R-FL) and Delaney (D-MD)

Give primary regulators an enhanced role: When an FSOC member is the primary regulator of a firm of industry sector under consideration by the council, that regulator should be given an enhanced role in related discussions and proceedings. For example, the primary regulator may be given formal opportunities to respond to questions and council resolutions.

American Action Forum, "Reform Principles for FSOC Designation Process (Cont'd)," January 2015

Improve the "Stage 2" SIFI designation process: FSOC should improve the clarity and transparency of the "Stage 2" SIFI designation process by:

- Notifying companies that they have been moved to "Stage 2" consideration;
- Giving considered companies access to information being used to evaluate them; and
- Publicly releasing a checklist of findings about a company along the six categories FSOC uses to evaluate a company: size, interconnectedness, leverage, substitutability, liquidity risk and maturity mismatch, and existing regulatory scrutiny.

American Action Forum, "Reform Principles for FSOC Designation Process (Cont'd)," January 2015

Document the designation process better: Following the designation of a company, FSOC should publicly release documentation of the process and an explanation for its designation decision. The documentation should mention specific activities or subsidiaries that FSOC believes constitute particularly serious threats to financial stability. It should also include any proposed alternatives to designation and why those alternatives were judged to be insufficient to mitigate threats to financial stability.

American Action Forum, "Reform Principles for FSOC Designation Process (Cont'd)," January 2015

FSOC REFORM: AN OVERVIEW OF RECENT PROPOSALS

PART II. REFORMING THE "SIFI" DESIGNATION PROCESS

ISSUE 6: FSOC's SIFI designation process is fundamentally flawed as currently designed. The process should be fixed, and designations should either be ended or delayed until the process flaws are addressed.

Establish a six-month moratorium on nonbank SIFI designations: FSOC may not designate any nonbank as a SIFI for six months following enactment. On June 20, 2014, this bill was amended in committee to increase the moratorium to one year.

To Place a 6-Month Moratorium on the Authority of the Financial Stability Oversight Council to Make Financial Stability Determinations (H.R. 4881), Neugebauer (R-TX)

Delay SIFI designations of nonbanks until regulatory rules are less bank-centric: FSOC should delay nonbank SIFI designations until the Federal Reserve knows and publicly states what prudential standards it will apply to those companies from nonbank industries, such as insurance companies and asset managers.

American Action Forum, "Reform Principles for FSOC Designation Process," November 2014

Raise the supermajority threshold and apply it to all FSOC actions: Any action taken by FSOC, including SIFI designation, should require the votes of three-quarters of the council. Currently, FSOC actions require either a two-thirds majority or a simple majority.

U.S. Chamber of Commerce, "Financial Stability Oversight Council Reform Agenda," August 2013

Ban funding for SIFI designation: Funds from this act may not be used to designate any nonbank financial company as a SIFI, or as "too-big-to-fail."

Financial Services and General Government Appropriations Act of 2015 (H.R. 5016), Crenshaw (R-FL)

FSOC REFORM: AN OVERVIEW OF RECENT PROPOSALS

PART II. REFORMING THE "SIFI" DESIGNATION PROCESS

ISSUE 7: Making "bank SIFIs" automatically subject to enhanced prudential standards is flawed. Congress should revamp its criteria.

Raise the "bank SIFI" threshold: Enhanced prudential requirements are not as appropriate or as cost-effective for medium-sized bank holding companies (BHCs). The threshold by which BHCs are automatically subject to such requirements should be raised, allowing financial regulatory agencies to focus their oversight on the most systemically important BHCs. Congress should:

- Raise the bank SIFI threshold from $50 billion to $250 billion and make it presumptive; that is, allow regulators discretion on whether to subject a BHC with assets lower than the threshold to enhanced requirements, or to not subject a BHC with assets higher than the threshold to those requirements.

Bipartisan Policy Center, "Dodd-Frank's Missed Opportunity: A Road Map for a More Effective Regulatory Architecture," April 2014

- Congress should raise the bank SIFI threshold, perhaps to $100 billion, and give regulators discretion on applying it to BHCs below that threshold.

Daniel K. Tarullo, Federal Reserve Board Governor, "Rethinking the Aims of Prudential Regulation," Speech at the Federal Reserve Bank of Chicago Bank Structure Conference, Chicago, Illinois, May 8, 2014

End automatic "bank SIFI" status and change evaluations criteria for designations:

- Instead of automatically subjecting BHCs with more than $50 billion in assets—sometimes called bank SIFIs—to heightened prudential standards like nonbank SIFIs, FSOC must evaluate and designate them using the same criteria it uses for nonbanks. Those criteria would be changed to the criteria used by the Basel Committee to designate global systemically important banks (G-SIFIs), which include the size, complexity, interconnectedness, substitutability, and global cross-jurisdictional activity of institutions. BHCs with assets of $50 billion or less would be exempted from possible designation.

- FSOC is prohibited from designating or evaluating BHCs for designation until the provisions of the legislation take effect, one year after enactment of the legislation. An exception is made for BHCs identified by the Financial Stability Board as G-SIFIs; FSOC may begin the evaluation process on these institutions upon enactment, but may not designate them until one year from the date of enactment.

Systemic Risk Designation Improvement Act of 2014 (H.R. 4060), Luetkemeyer (R-MO)

FSOC REFORM: AN OVERVIEW OF RECENT PROPOSALS

PART II. REFORMING THE "SIFI" DESIGNATION PROCESS

ISSUE 8: FSOC does not currently have a clear, formal process for nonbank financial institutions designated as SIFIs to later be "de-designated" so that they no longer face enhanced prudential supervision. FSOC should clarify its de-designation processes and improve its communications with companies throughout.

Establish a more robust SIFI de-designation process: FSOC should determine criteria and a process for SIFIs to achieve "de-designation."

U.S. Chamber of Commerce, "Financial Stability Oversight Council Reform Agenda," August 2013

Provide detailed reasoning for not de-designating a SIFI: If a SIFI's status is not rescinded, FSOC should provide the company with a detailed assessment of each statutory consideration FSOC must evaluate, as well as why actions taken by the company did remove the threat(s) to financial stability that caused FSOC to designate the company.

SIFMA et al., "Petition for Financial Stability Oversight Council Rulemaking Regarding the Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies," August 2014

Amend the formal re-evaluation process: FSOC must give written notice to all designated SIFIs when their designations are annually reevaluated and must allow those SIFIs to submit written materials and to contest the designations. In addition, FSOC must conduct a separate re-evaluation upon SIFI request, which can be made every five years.

Financial Stability Oversight Improvement Act of 2014 (H.R. 5180), Ross (R-FL) and Delaney (D-MD)

FSOC REFORM: AN OVERVIEW OF RECENT PROPOSALS

PART II. REFORMING THE "SIFI" DESIGNATION PROCESS

ISSUE 9: FSOC has not adequately analyzed whether the benefits of its actions, including designation, outweigh the costs. FSOC should develop and conduct formal cost-benefit analyses.

Require designation impact studies every five years: Every five years, FSOC must study and report on the impact of SIFI designations on the economy and financial stability, whether any of FSOC's designations should be rescinded, or whether any related FSOC regulations or guidance should be changed.

Financial Stability Oversight Improvement Act of 2014 (H.R. 5180), Ross (R-FL) and Delaney (D-MD)

Study the impacts of SIFI designation. FSOC should develop a framework for assessing the impact of its designations on the economy and on SIFIs. This framework should establish a baseline for measuring the effects of new regulatory standards, requirements and restrictions on such companies.

Government Accountability Office, "New Council and Research Office Should Strengthen Accountability and Transparency of Decisions," September 2012

Weigh costs and benefits, making FSOC actions more predictable while preserving discretion: FSOC should analyze the costs and benefits of the actions it takes and justify those actions in that context. Member agencies should do the same when dealing with issues that have systemic significance.

Donald Kohn, Member of the United Kingdom's Financial Policy Committee and former Federal Reserve Board Vice Chairman, "Institutions For Macroprudential Regulation: The U.K. and the U.S.," Speech at the Kennedy School of Government, Harvard University, Cambridge, Massachusetts, April 2014

Establish SIFI designation impact studies: FSOC should fully assess the economic costs of a company's failure and the costs and benefits of designation during the designation process.

American Action Forum, "Reform Principles for FSOC Designation Process," November 2014

FSOC REFORM: AN OVERVIEW OF RECENT PROPOSALS

Part III. REVAMPING FSOC'S STRUCTURE AND MEMBERSHIP

ISSUE 10: FSOC was not designed to allow it to fulfill the mandates it was given. FSOC's structure and authorities should be revamped to better align with its mandates.

Strengthen FSOC's existing legal authorities: Congress should give FSOC authority to issue regulations on its own via a supermajority vote when:

- One or more agencies fail to meet a congressionally mandated deadline for finalizing a regulation on their own by more than 180 days; and
- To address serious and material threats to financial stability, either when:
- One or more member agencies fails to act to address such a threat; or
- The council determines that heightened safeguards and standards are needed to address such a threat.

Bipartisan Policy Center, "Dodd-Frank's Missed Opportunity: A Road Map for a More Effective Regulatory Architecture," April 2014 also: Bipartisan Policy Center, "Responding to Systemic Risk: Restoring the Balance," September 2014

Change FSOC's voting structure so that agencies with objectives most oriented toward financial stability are the ones that are empowered to vote:

- The Office of Financial Research (OFR) director becomes a voting member; and
- The National Credit Union Administration chair becomes a non-voting member.

Bipartisan Policy Center, "Dodd-Frank's Missed Opportunity: A Road Map for a More Effective Regulatory Architecture," April 2014

Ensure SIFI regulators have industry expertise: A nonbank SIFI's primary regulator should be the prudential regulator it had before designation rather than the Federal Reserve. This ensures that the primary regulator has expertise in the relevant industry.

U.S. Chamber of Commerce, "Financial Stability Oversight Council Reform Agenda," August 2013

Add macroprudential tools: FSOC should be given additional tools to address potential systemic risks. This might include expecting FSOC to make regular recommendations on the countercyclical buffer for banks and the appropriateness of capital and other prudential requirements in addressing risks that may build outside the banking sector. Further, FSOC should be able to fast-track the response period for its recommendations when necessary.

Donald Kohn, Member of the United Kingdom's Financial Policy Committee and former Federal Reserve Board Vice Chairman, "Institutions For Macroprudential Regulation: The U.K. and the U.S.," Speech at the Kennedy School of Government, Harvard University, Cambridge, Massachusetts, April 2014

Improve annual reports: FSOC should improve its annual report by specifying which member agencies should take and monitor recommended actions, and within what time frame. It should also create systematic forward-looking approaches to reporting on potential threats to financial stability in FSOC annual reports.

Government Accountability Office, "New Council and Research Office Should Strengthen Accountability and Transparency of Decisions," September 2012

FSOC REFORM: AN OVERVIEW OF RECENT PROPOSALS

Part III. REVAMPING FSOC'S STRUCTURE AND MEMBERSHIP

ISSUE 11: FSOC members that represent boards or commissions do not always reflect the views of their full boards or commissions. FSOC's voting structure should be revamped to include a wider range of views while preserving the independence of the council and its member agencies.

Broaden FSOC meeting representation: Members of congressional FSOC oversight committees may attend all FSOC meetings. All FSOC meetings, other than meetings of the members themselves, will be open to staff of the House Financial Services and Senate Banking committees and to staff of FSOC member agencies that FSOC members have selected to attend.

FSOC Transparency and Accountability Act (H.R. 4387), Garrett (R-NJ)

Require FSOC members to vote on behalf of their agency: The voting position taken by FSOC members that chair financial agencies overseen by commissions or boards must represent their full commissions or boards.

FSOC Transparency and Accountability Act (H.R. 4387), Garrett (R-NJ)

Seek out divergent views within member agencies: FSOC members representing commissions or boards should consult with their fellow commissioners or board members on FSOC matters, and FSOC staff working groups should include staff from other commissioners and board members.

U.S. Chamber of Commerce, "Financial Stability Oversight Council Reform Agenda," August 2013

Establish greater independence for the council:

- FSOC should be led by an independent, Senate-confirmed FSOC chair, who would be a new voting member. Currently, the secretary of the Treasury is chairman of FSOC and would remain an FSOC voting member and take a lead role when public money is involved.
- FSOC should be set up as an independent office within Treasury, such as the Office of the Comptroller of the Currency, or as a fully independent agency outside the purview of the Treasury secretary.
- FSOC should have independent staff and funding, which could be accomplished by folding the OFR, which sets its own funding, into FSOC.

Donald Kohn, Member of the United Kingdom's Financial Policy Committee and former Federal Reserve Board Vice Chairman, "Institutions For Macroprudential Regulation: The U.K. and the U.S.," Speech at the Kennedy School of Government, Harvard University, Cambridge, Massachusetts, April 2014

FSOC REFORM: AN OVERVIEW OF RECENT PROPOSALS

Part III. REVAMPING FSOC'S STRUCTURE AND MEMBERSHIP

ISSUE 12: FSOC's work is often duplicative and inefficient. FSOC could improve its effectiveness by improving collaboration among its member agencies and clarifying responsibilities and future needs.

Clarify financial-stability-monitoring responsibilities: FSOC should clarify the responsibilities of the council and its members for monitoring threats to financial stability to ensure comprehensiveness and avoid duplication.

Government Accountability Office, "New Council and Research Office Should Strengthen Accountability and Transparency of Decisions," September 2012

Improving data-sharing: FSOC should require agencies to share data with FSOC/OFR and other member agencies upon request, and to respond to FSOC requests to collect additional data, rather than working through ad hoc methods or memoranda of understanding.

Donald Kohn, Member of the United Kingdom's Financial Policy Committee and former Federal Reserve Board Vice Chairman, "Institutions For Macroprudential Regulation: The U.K. and the U.S.," Speech at the Kennedy School of Government, Harvard University, Cambridge, Massachusetts, April 2014

Improve information-sharing and coordination: FSOC should systematically share key financial risk indicators across FSOC member agencies to help in identifying potential systemic threats. It should also establish formal policies, and incorporate best practices, for collaboration and coordination between agencies.

Government Accountability Office, "New Council and Research Office Should Strengthen Accountability and Transparency of Decisions," September 2012

Establish an annual regulatory perimeter assessment: FSOC should include an assessment of risks that are building outside of the most heavily regulated financial sectors (i.e., the "regulatory perimeter") in its annual report and provide recommendations to address them.

Donald Kohn, Member of the United Kingdom's Financial Policy Committee and former Federal Reserve Board Vice Chairman, "Institutions For Macroprudential Regulation: The U.K. and the U.S.," Speech at the Kennedy School of Government, Harvard University, Cambridge, Massachusetts, April 2014

Assign each FSOC agency a financial stability objective: Doing so would better align the goals of member agencies with the goals of the council.

Donald Kohn, Member of the United Kingdom's Financial Policy Committee and former Federal Reserve Board Vice Chairman, "Institutions For Macroprudential Regulation: The U.K. and the U.S.," Speech at the Kennedy School of Government, Harvard University, Cambridge, Massachusetts, April 2014

LETTER OF DISSENT SUBMITTED BY BENJAMIN M. LAWSKY, SUPERINTENDENT, NEW YORK DEPARTMENT OF FINANCIAL SERVICES

NEW YORK STATE
DEPARTMENT *of*
FINANCIAL SERVICES

Andrew M. Cuomo
Governor

Benjamin M. Lawsky
Superintendent

July 30, 2014

The Honorable Jacob Lew
Secretary
Department of the Treasury
1500 Pennsylvania Ave., NW
Washington, DC 20220

Dear Secretary Lew:

In 2013, MetLife, Inc. ("MetLife") publicly announced that it had reached "Stage 3" in the Financial Stability Oversight Council ("FSOC") process for determining whether the company should be designated a nonbank systemically important financial institution ("SIFI") under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("DFA").

The New York Department of Financial Services ("DFS") supervises MetLife's largest insurance subsidiary, and serves as the lead insurance regulator for the MetLife group of companies. DFS oversees all licensed insurance companies in New York, as well as state-chartered banks, credit unions, foreign bank branches, and other financial institutions.

It is our understanding that the FSOC soon will be voting on whether MetLife should be designated as a SIFI. Before rendering that determination, we believe that FSOC must carefully consider three critical factors – namely, that MetLife does not engage in any non-traditional, non-insurance activities that create any appreciable systemic risk; that, in the event that MetLife or one or more of its insurance subsidiaries were to fail, DFS and other state regulators would be able to ensure an orderly resolution of the enterprise; and that MetLife's life insurance businesses already are closely and carefully regulated by DFS and other regulators.

1. MetLife does not engage in non-traditional non-insurance activities that create any appreciable systemic risk.

Insurance regulation differs qualitatively from banking regulation. An insurer's liabilities take the form of collecting premiums in exchange for a promise to pay upon the occurrence of a fortuitous future event that is beyond the control of either the insurer or the insured party. A bank's liabilities, by contrast, take the form of promises to repay its depositors' funds upon demand at any time no matter how short the notice.

This difference between the contractual promises insurers make and the on-demand nature of bank deposits means that the life insurance business is less susceptible to liquidity problems or mismatch between asset and liability maturity than banking. Bank deposits create immediate potential liabilities while the bank invests in assets that mature over time. Banks therefore rely heavily on their depositors' faith in the institution and the fact that all depositors are unlikely to

demand their funds at the same moment. If that faith is shaken, large numbers of depositors may seek to withdraw their funds at the same time, thereby creating a "run on the bank."

There is much less "run risk" for a life insurer like MetLife. Life insurance liabilities develop over time because the insurer is not obligated to pay until the occurrence of the insured event like death. Actuarial forecasting and the law of large numbers make such events relatively predictable in the aggregate. Life insurers are therefore able to match their various investment maturity dates with relatively predictable long-term liabilities.

To be sure, many products offered by life insurers allow policyholders to access a certain amount of immediate value from the contract. However, even at the height of the most extreme distressed scenario that the U.S. has confronted since the Great Depression – the Great Recession that began in 2007 – at no time was there any indication that MetLife lacked the liquidity to address, let alone experienced any financial stress to meet, the short-term demands of any of its contractholders.

That is not to say, however, that the operations of an insurance holding company can never pose a systemic risk. Indeed, the recent financial crisis highlighted how the activities of AIG's holding company could threaten the global financial system by engaging in risk-taking outside the framework of traditional banking or insurance regulation.

The risks associated with non-traditional non-insurance activities that felled AIG, however, are decidedly diminished in the case of MetLife. For starters, the overwhelming majority of MetLife's liabilities are obligations to policyholders made by its insurance subsidiaries, which are backed by high-quality assets that DFS and other insurance regulators monitor. Put differently, MetLife's operations are not nearly as diverse and far flung as AIG's; whereas AIG ran an airline leasing business and engaged in other activities with little or no nexus to insurance, MetLife's activities are more closely tethered to the business of insurance *qua* insurance.

MetLife does have an extensive derivatives program, which is subject to review and careful surveillance by DFS and other state regulators. But unlike the case of AIG, MetLife's program is well collateralized, conducted almost exclusively for hedging purposes, and not concentrated in any counterparty or group of counterparties. And whereas AIG's securities lending program exacerbated its stress, MetLife conducts its securities lending program within its life insurance subsidiaries alone, which in New York means the program is subject to restrictions on size, concentration limits, and counterparty creditworthiness.

In short, MetLife does not appear to engage in non-traditional non-insurance activities that create any appreciable risk to the global financial system.

2. In the event that MetLife or one or more of its insurance subsidiaries were to fail, DFS and other regulators would be able to ensure an orderly resolution.

The nature of the fundamental insurance promise discussed above makes insurance companies considerably easier to resolve successfully than banks. Because the life insurance business is based on contractual liabilities that develop over time, life insurance failures are relatively slow

moving. Regulators can generally intervene early when significant assets are still available, and commence a receivership that runs off the liabilities against the assets as they mature. And all the while, policyholders benefit from a guaranty fund system that keeps their losses, if any, to a minimum.

State insurance regulators have numerous tools at their disposal to manage insurer insolvencies. Indeed, even before a receivership is commenced, regulators have the power to direct insurers to cease writing new business, and can suspend claims payments and other expenses to stave off short-term liquidity shortfalls. In 2013, New York successfully resolved FGIC, a monoline guaranty insurer with hundreds of billions of dollars of notional exposure, by utilizing these tools and working with creditors to develop a court-approved rehabilitation plan.

If MetLife and its subsidiaries were to fail, it would undoubtedly present a challenging situation for state insurance regulators and the guaranty fund system. But that is a far cry from saying that resolution would be difficult, or even impossible, to achieve. Notwithstanding MetLife's scale and size – which, in terms of companies, is only about one-fifth the size of AIG – each of MetLife's subsidiaries is separately capitalized, and could be separately and orderly resolved by existing regulatory authorities.

3. MetLife is already closely and carefully regulated by DFS and other regulators.

MetLife is indisputably one of the largest financial institutions in the United States by almost any measure, but the DFA makes clear that size alone is not dispositive to the SIFI designation process. Rather, the FSOC must consider many factors, including the effectiveness of existing regulation.

The state-based insurance regulatory system amply protected MetLife's policyholders and the broader financial system from the risk of MetLife's failure during the recent financial crisis. DFS and other state regulators who supervise each MetLife insurance subsidiary employ a wide array of tools to ensure solvency, including limitations on the type and concentration of invested assets; conservative risk-based capital and reserving requirements focused on early intervention in times of distress; review of filed derivative use plans; prior approval of intercompany transactions; prior approval of new policy types, rates, and lines of business; annual and quarterly financial reporting; statutory accounting requirements that are more conservative than generally accepted accounting principles; and constant and ongoing supervision and examination.

State regulators coordinate activities with one another, as well as with international regulators who supervise MetLife's foreign subsidiaries. To that end, DFS hosts an annual supervisory college for MetLife's regulators from around the globe, with telephonic meetings in the interim to facilitate collaboration, cooperation, and coordination among supervisors.

Further, in the wake of the financial crisis, New York and other state regulators have adopted a number of measures to strengthen the state supervisory system, including revision of insurance holding company laws that vest regulators with greater authority to monitor and examine insurance holding companies and their non-insurance subsidiaries; improvement of

methodologies for valuing mortgage-backed securities, which avoid reliance on the judgments of ratings agencies; development of new restrictions on insurer securities lending programs and the use of derivatives; and development of new requirements obligating companies to develop a risk management function on an enterprise-wide basis. The measures are intended to ensure that MetLife remains subject to effective and continuous oversight by DFS and others. DFS has also been a leader in attempting to head off changes to the state-based system that might weaken policyholder protections. For example, we have vigorously opposed a move to "principles-based reserving" and we have raised alarms about the use of captive reinsurance arrangements and called for a national moratorium on captive transactions used to artificially lower reserve and collateral requirements. Suffice it to say, MetLife has an active primary regulator carefully monitoring the conditions of the firm.

Conclusion

For the foregoing reasons, before rendering any determination finding that MetLife is a systemically important nonbank financial institution, FSOC should carefully consider the three factors discussed above. As MetLife's primary insurance regulator, we stand ready and willing to answer any questions that you may have.

Sincerely,

Benjamin M. Lawsky
Superintendent of Financial Services

cc: Richard Cordray, Director
Consumer Financial Protection Bureau

Thomas J. Curry, Comptroller of the Currency
Office of the Comptroller of the Currency

Martin J. Gruenberg, Chairman
Federal Deposit Insurance Corporation

John M. Huff, Director
Missouri Department of Insurance

Debbie Matz, Chairman
National Credit Union Administration

Michael T. McRaith, Director
Federal Insurance Office

Melvin L. Watt, Director
Federal Housing Finance Agency

Mark P. Wetjen, Acting Chairman
Commodity Futures Trading Commission

Mary Jo White, Chair
Securities and Exchange Commission

S. Roy Woodall, Independent Member with Insurance Expertise
FSOC

Janet L. Yellen, Chairman
Board of Governors of the Federal Reserve System

ROY WOODALL AND JOHN HUFF DISSENTS ON PRUDENTIAL

The following is a public version of the dissent of the Council's Independent Member delivered to Council Members.

Views of the Council's Independent Member having Insurance Expertise

As the Financial Stability Oversight Council's (the "Council") Independent Member having insurance expertise, I dissent from the Final Determination of the Council that, based on the analysis and conclusions presented in the Basis for the Financial Stability Oversight Council's Final Determination Regarding Prudential Financial, Inc. ("Basis") and the administrative record, the material financial distress of Prudential Financial, Inc. ("Prudential") could pose a threat to the financial stability of the United States.[1]

In making its Final Determination, the Council has adopted the analysis contained in the Basis. Key aspects of said analysis are not supported by the record or actual experience; and, therefore, are not persuasive. The underlying analysis utilizes scenarios that are antithetical to a fundamental and seasoned understanding of the business of insurance, the insurance regulatory environment, and the state insurance company resolution and guaranty fund systems. As presented, therefore, the analysis makes it impossible for me to concur because the grounds for the Final Determination are simply not reasonable or defensible, and provide no basis for me to concur.

Many of my views, as well as those of Director Huff and others, are underscored by arguments presented by Prudential in response to the Council's earlier Proposed Determination analysis. What follows represents the most serious of my major points of disagreement with the rationale for the Final Determination.

Transmission Channels

The Council identified three transmission channels as avenues by which a nonbank financial company could transmit risk of instability to the financial system: (1) exposure; (2) asset liquidation; and (3) critical function or service. The Council has determined that Prudential's material financial distress could pose a threat to financial stability focusing on two of the channels: exposure and asset liquidation.[2]

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[1] The Council has based its conclusion solely on what is referred to as the First Determination Standard; namely: "material financial distress at the nonbank financial company could pose a threat to the financial stability of the United States." *See* Appendix A to Part 1310 – Financial Stability Oversight Council Guidance for Nonbank Financial Company Determinations ("Interpretive Guidance"), 12 C.F.R. pt. 1310, app. A (2013). The Council did not consider Prudential under the "Second Determination Standard," which relates to specific activities of the company, as discussed further below.

[2] Prudential's share of generally fragmented and competitive markets does not appear large enough to cause a significant disruption in the provision of services should Prudential experience material financial distress and be unable or unwilling to provide such services.

(1) Exposure Transmission Channel

The Council's Interpretive Guidance explains that its consideration of the exposure channel would involve exposures "significant enough to materially impair" creditors, counterparties, investors, or other market participants.[3]

Neither the Basis nor the administrative record supports the conclusion that the exposure of Prudential's creditors, counterparties, investors, and other market participants to Prudential are significant enough that Prudential's material financial distress could *materially impair* those entities and thereby could pose a threat to U.S. financial stability. No specific adverse effect on the financial condition of those other entities is presented to support any conclusion of material impairment. Absent supporting analysis regarding the resulting financial condition of those entities, it is not possible to make such a conclusion.

The Basis does not establish that any individual counterparty would be materially impaired because of losses resulting from exposure to Prudential. Instead, the Basis relies on broader market effects and aggregates the relatively small individual exposures to conclude that exposures across multiple markets and financial products are significant enough that material financial distress at Prudential could contribute to a material impairment in the functioning of key financial markets. Although aggregate exposures are large, individual losses may be able to be absorbed by counterparties or policyholders without materially impairing financial condition, financial services or economic activity.

I do not agree, without further supporting analysis, that relatively small exposures spread among many financial institutions would materially impair these same institutions simply because of broader market effects. Moreover, such a line of reasoning would inevitably lead to a conclusion that any nonbank financial company above a certain size is a threat – contradicting pronouncements that "size alone" is not the test for determination.

The assumed failure of Prudential, both at the holding company level and across *all* of its subsidiaries, would be a significant market event leading to destabilizing and negative effects for individuals, firms, and markets. The Basis reasonably predicts where the relatively small losses would fall. But while losses borne broadly among financial market participants would have a small impact on their capital, the conclusion that these exposures could serve to spread material financial distress at Prudential to counterparties and financial markets more broadly is not supported by the Basis or the administrative record. In addition, the other impacts noted in the Basis regarding potential effects on policyholders, state guaranty funds, or other insurers are not convincing.

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[3] Interpretive Guidance, 12 C.F.R. pt. 1310, app. A (2013).

(2) Asset Liquidation Transmission Channel

The Council's asset liquidation channel hinges on an assumed run by *millions* of life insurance policyholders, who would collectively surrender or withdraw a significant portion of life insurance cash values. In addition to alleging that such withdrawal and surrender requests could strain Prudential's liquidity resources to meet such a run with all of its insurance subsidiaries being rendered insolvent, put into receivership, and liquidated, the Basis postulates that such a run could cause liquidity runs on other life insurers. In addition to a run by life insurance policyholders, the Basis appears to assume that separate account holders, like variable annuity and other contract holders, would also run *en masse*, causing asset liquidations, and that these consequences would lead to financial instability.

The Council's analysis is flawed in several significant respects.

- While there have in fact been liquidity runs on life insurance companies, no historical, quantitative or qualitative evidence exists in the record that supports a run of the scale and speed posited, or to support a rapidly spreading sector-wide run. The asset liquidation analysis appears to assume a contemporaneous run against the general and separate accounts by *millions of* life insurance policyholders and a significant number of annuity and other contract holders of products with cash surrender value – a scale for which there is no precedent, and for which the likelihood is believed by most experts to be extraordinarily low. The Basis provides no support for why such a construct is warranted or reasonable. Other more plausible failure hypotheses could have been used.

- The run behavior assumed in the Basis is a homogenous view of Prudential's policy and contract holders in disregard of important distinctions in behaviors of institutional versus retail customers; customer demographics and domicile; an insured's health; economic, market risk, penalty, tax and substitution disincentives; and product type and design (i.e., terms and conditions). There also appears to be a false perception, contradicted by facts and experience, that policyholders value life insurance only or primarily as cash instruments.

- The First Determination Standard requires that the Council consider Prudential, as the parent holding company, to be in material financial distress, but such distress does not necessarily include the material financial distress of all of its major insurance subsidiaries. The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank")[4] does not require the Council to presume an unfathomable and inexplicable simultaneous insolvency and liquidation of all insurance subsidiaries, and to do so confuses failure at the holding company level with failure at the operating insurance entity level. Nevertheless such an approach highlights the fact that the Notice's analysis

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[4] Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), Pub. L. No. 111-203, 124 Stat. 1376 (2010).

under the First Determination Standard is dependent upon its misplaced assumptions of the simultaneous failure of all of Prudential's insurance subsidiaries and a massive and unprecedented, lightning, bank-style run by a significant number of its cash value policyholders and separate account holders, which apparently is the only circumstance in which the Basis concludes that Prudential could pose a threat to financial stability. I believe that, absent a catastrophic mortality event (which would affect the entire sector and also the whole economy), such a corporate cataclysm could not and would not occur.

- One of the key bases underpinning the Basis is the proposition that a significant portion of U.S. general account cash surrender values would be payable within a very short period of time and that Prudential would be unable to accommodate such a large cash outflow, thereby incentivizing other "runners" from Prudential's life insurance companies as well as other non-affiliated life insurance companies. The existing built-in fail-safes of insurance and annuity product terms and conditions, and Federal and State regulatory and judicial stay authorities – all combine to impede the transmission and slow the potential asset liquidation to a point that it could be managed by Prudential. The Basis rightly notes that any asset liquidation could be slowed by certain mitigating factors, such as Prudential deferring payouts on a significant portion of the immediately payable cash surrender values or the imposition of stays on withdrawals and surrender by state courts. The Basis contends though that these tools could affect market confidence in the life insurance sector as a whole, and possibly trigger surrenders and withdrawals at other insurers. Even assuming arguendo that such fail-safes might perhaps lead to other negative effects,[5] the alleged threat to financial stability from a feared rapid asset liquidation can be countered.

- Runs from separate accounts and asset management accounts are indistinguishable from a market perspective. Therefore, it is difficult to reconcile the Basis's analysis of assumed runs and forced asset liquidation tied to separate account products and its skepticism as to the sale or transfer of whole companies or blocks of such business, with its different conclusions as to a possible reputational run, asset liquidation, and transfers of Prudential's asset management business.

- The Basis does not give enough weight to mitigants and appears to question both the professional judgments of regulators to intervene and the effectiveness of stays to stop runs. Such reasoning suggests a misled and partial or incomplete understanding of state-based insurance regulatory system guided by mandatory interventions under State risk-based capital laws. In fact, not only the U.S. State insurance regulators, but also the

[5] It is also equally plausible that the use of such existing fail-safes might engender greater confidence in the protections afforded insurance consumers and in the regulatory system, and thereby result in long-term positive effects.

Securities and Exchange Commission ("SEC"),[6] and Japan's Financial Services Agency, all have the authority to impose early stays. These stays would almost certainly stop any runs and halt the resulting asset liquidations that the Basis indicates would lead to severe impairments of financial intermediation or financial market functioning that would significantly damage the economy.

- Having already contemplated Prudential and its insurance subsidiaries to be in material financial distress, insolvent, and in liquidation, the Basis's analysis becomes distracted by certain solvency issues, such as captive reinsurance.[7]

- The Basis's reliance on the lack of a precedent for a failure of an insurance company the size and scale of Prudential begs the question. The question that should be asked is why there has been no such precedent? It seems inherently unreasonable to make negative inferences about the current state resolution and guaranty systems based on the lack of such precedent, while presuming material financial distress and the failure across all insurance subsidiaries; without a reasonable and complete assessment of the extremely low probability of such a scenario occurring. Even though Prudential does not currently have a consolidated regulator, there are many U.S. and non-U.S. regulators overseeing Prudential's operating entities. That there is "no precedent" is, in large part, a testament to the proven results of State insurance regulators, individually and collectively working through the National Association of Insurance Commissioners ("NAIC"), in strengthening the quality, depth and sophistication of the State regulatory framework for its legal entity supervision, particularly over the last two decades.[8]

- The Basis also does not give sufficient credence to the ability of the state resolution and guaranty systems to serve as a mitigant.

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[6] Section 22(e) of the Investment Company Act prohibits suspension of redemptions and provides a seven-day window for payment of proceeds. However, Section 22(e)(2), and (3) provide authority for the SEC to grant relief from the statute, through rulemaking or an exemptive order.

[7] Use of affiliated captive reinsurance by life insurers is a notable trend and State insurance regulators face serious challenges in reaching a consensus approach to reform. I favor the Council making recommendations to the primary financial regulators and the Board with respect to capital treatment on a consolidated basis. However, for purposes of the analysis at hand, captive reinsurance has only limited relevance as a potential amplifier of loss exposure to counterparties given the arbitrage of capital quality, but which the analysis does not quantify. Captive reinsurance would be more relevant to the analysis had the Council relied on credit risk to cedent affiliates as a basis in modeling which insurance subsidiaries might become distressed or insolvent, leading to a more plausible scenario of transmission through the resolution and the guaranty systems. However, under the analysis, the insolvency and failure of all insurance subsidiaries is presumed, making issues of affiliate risk and capital transfer less important.

[8] Moreover, the Basis's analysis confuses material financial distress at the holding company level with distress at the operating entity level. Prudential is a diversified financial conglomerate, not an operating insurer.

Significant Damage to the Broader Economy

The Basis and the administrative record lack any analysis as to how Prudential's material financial distress would lead to a threat where "there would be an impairment of financial intermediation or financial market functioning that would be sufficiently severe to inflict *significant damage on the broader economy*."[9] The Basis does not contain any analysis that presents any findings as to severe impairment of financial intermediation; severe impairment of the functioning of U.S. and global financial markets; or resulting significant damage to the economy. No empirical evidence is presented; no data is reviewed; no models are put forward. There is simply no support to link Prudential's material financial distress to *severe* consequences to markets leading to *significant* economic damage.

Conclusion

In view of my disagreement with the rationale in the Basis concerning the major areas discussed above, I respectfully dissent from the Council's Final Determination. I also have other reservations and concerns, as set forth below.

Other Reservations and Concerns

In addition to the dissent from the Final Determination discussed above, several other matters have also weighed heavily on my consideration of this determination.

(1) First and Second Determination Standards

After including extensive review of the profile of Prudential and its activities under the First Determination Standard, the Council decided to not evaluate Prudential under the Second Determination Standard. Given the questionable and unreasonable basis for the Council's reliance solely on the First Determination Standard, it is my position that it would have been prudent for the Council also to have considered the Second Determination Standard pertaining to activities.

This absence from the analysis is regrettable, as much of the public discussion and the focus of regulators (domestic and international), policymakers, academics, and industry participants has been on activities. As a result, the Council's decision to designate Prudential will provide no direction, clarity or transparency to the public or to State insurance regulators, international supervisors, or Prudential itself, as to what activities need to be addressed or modified. The Council fails to make any recommendation to the primary financial regulatory agencies[10] or the Federal Reserve Board of Governors ("Board of Governors"), as anticipated (and provided for) in Dodd-Frank as well as in the Council's own Interpretive Guidance.[11] The analysis should

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[9] Interpretive Guidance, 12 C.F.R. pt. 1310, app. A (2013) (emphasis added).
[10] Dodd-Frank §112(k), 12 U.S.C. §5322(k).
[11] Interpretive Guidance, 12 C.F.R. pt. 1310, app. A (2013).

have identified any risky or disfavored activities conducted by Prudential; and, in so doing, the Council would have provided needed and useful guidance to inform on-going domestic and international efforts to strengthen the stability of the insurance sector and the financial system as a whole.

(2) The Collins Amendment

A determination by the Council that Prudential could pose a threat to financial stability is a prerequisite to its determination whether to subject the company to supervision by the Board of Governors. A plain reading of Section 113 of Dodd-Frank sets out a two-part determination process whereby:

1. "*if the council determines* that material financial distress at the U.S. nonbank financial company, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the U.S. nonbank financial company, could pose a threat to the financial stability of the United States[;]"

2. "[it] *may determine* that a U.S. nonbank financial company shall be supervised by the Board of Governors and shall be subject to prudential standards, in accordance with this title[.]"[12]

The penultimate question is whether to subject Prudential to Board of Governors supervision, which is a significant regulatory action. Irrespective of the separate determination as to whether the company could pose a threat to financial stability, I believe that the Council should exercise its discretion and defer a Final Determination as to whether Prudential should be supervised by the Board of Governors and subject to enhanced prudential standards at this time.

The Council's Final Determination will subject the company to a new supervisory and capital regime.[13] However, the Basis is silent as to any possible alternative considerations.

It is critical that more consideration be given to the regulatory capital regime that would be imposed on Prudential or any consolidated organization predominated by insurance companies under Board of Governors supervision, especially minimum capital requirements pursuant to section 171 of the Dodd-Frank (commonly referred to as the "Collins Amendment"). The Council's Final Determination that Prudential should be supervised by the Board of Governors will ultimately lead to the imposition of requirements that are by all indications ill-suited for

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[12] Dodd-Frank §113(a)(1), 12 U.S.C. §5323(a)(1) (emphasis added).

[13] I am not advocating for lower capital requirements. In some circumstances higher capital requirements may be necessary. But I am in favor of capital requirements that are appropriate and that make sense.

insurance companies; and when, unfortunately, the Board of Governors may be constrained in tailoring.[14]

It is generally conceded that the Collins Amendment's requirements could potentially have a significant impact on Prudential. The possible unintended negative consequences to consumers, the insurance marketplace, and the broader economy are not at all clear at this point. The competitive disadvantage for Prudential relative to other peers remains a concern.

Time is not of the essence in this case, for Prudential is not in financial distress, material or otherwise. There is no suggestion that it poses an actual threat to U.S. financial stability.[15] There are no exigent (emergency) circumstances,[16] and no specific threatening activities have been identified.

In light of this, the Council should actually refrain from making a final determination and should instead employ other tools or methods at its disposal to address risks, such as subjecting Prudential to on-going, heightened monitoring. The Council could then use this additional time to consider making recommendations to the Board of Governors as to the Collins Amendment.[17] In addition, the Council should make recommendations to Congress pertaining to the Collins Amendment, including any needed legislation.

(3) Systematic Risk versus Idiosyncratic Risk to the System

The Basis is also flawed in its approach to overall systematic risk that could apparently be triggered *via* the state-based resolution and guaranty systems by other large life insurance companies – not just Prudential. It should be recognized that the Board of Governors, as consolidated regulator, has no authority under Dodd-Frank Section 165 to address systemic risk presented by any perceived flaws in state resolution processes or state guaranty funds (absent the guaranty funds themselves being designated).[18] To the contrary, state-based resolution of insurance companies and guarantee protections are preserved, as is, in Title 2 of Dodd-Frank.[19] Yet in spite of its apparent concerns, the Council has taken no other action, nor made or tabled for consideration any recommendations to the primary financial regulators, the States, or Congress as to the state resolution and guaranty systems.

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[14] The Board of Governors has authority under section 165 to tailor the application of the standards, including differentiating among covered companies on an individual basis or by category. *See* Dodd-Frank §165(a)(2)(A), 12 U.S.C. §5356(a)(2)(A). However, this does not address the potential restraint on the Board of Governors in tailoring those standards due to the Collins Amendment.

[15] Dodd-Frank §121, 12 U.S.C. §5331.

[16] Dodd-Frank §113(f), 12 U.S.C. §5323(f).

[17] Dodd-Frank §§115(a)(2), 112(2)(I), 12 U.S.C. §§5325(a)(2), 5322(2)(I).

[18] The state guaranty funds themselves could possibly qualify as nonbank financial companies eligible for designation.

[19] Dodd-Frank §203(e), 12 U.S.C. §5383(e).

(4) Recent Regulatory Scrutiny by the Global Insurance Regulators, Finance Ministers, and Central Bankers

The Basis omits any mention of recent international regulatory scrutiny of Prudential. On July 18, 2013, the Financial Stability Board ("FSB") announced that, in consultation with the IAIS and "national authorities," the FSB had identified an initial list of nine global systemically important insurers ("G-SIIs").[20] The FSB list identified Prudential as a G-SII. It appears that the U.S. "national authority" apparently assented to the FSB designation of Prudential as a G-SII – even prior to Prudential's evidentiary hearing before the Council on its Proposed Determination and to any final decision by the Council.[21] It seems reasonable to conclude from the spirit and intent of Dodd-Frank that the Council is the primary national authority in the U.S. responsible for financial stability and designating systemically important companies.

Although not binding on the Council's decision, the declaration of Prudential as a G-SII by the FSB based on the assessment by the U.S. and global insurance regulators, supervisors, and others who are members of the IAIS,[22] has overtaken the Council's own determination process. While the FSB's action should have no influence, I have come to be concerned that the international and domestic processes may not be entirely separate and distinct, especially where the FSB pronouncements of policy measures to be imposed on the G-SIIs, including Prudential, can only be achieved in the U.S. through a subsequent Council designation.[23] Thus, the action by the FSB interjects a new consideration for me to weigh in that the failure of the Council in not designating Prudential could be viewed to be a failure of the U.S. to comply with decisions made within the G-20.

In considering these new international issues, I am at a disadvantage, particularly in not being privy to the deliberations, insights and results of the methodological assessment of the IAIS and its members, which developed the underlying basis for the FSB's action, in spite of the Council's information-sharing Memorandum of Understanding.

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[20] The FSB is currently working to identify global systemically important financial institutions ("G-SIFIs") in furtherance of the financial regulatory reform agenda of the Group of Twenty Finance Ministers and Central Bank Governors ("G-20"). G-SIFIs are defined by the FSB as "institutions of such size, market importance, and global interconnectedness that their distress or failure would cause significant dislocation in the global financial system and adverse economic consequences across a range of countries;" and G-SIIs are one class of SIFIs.

[21] The FSB also designated MetLife, Inc. as a G-SII, without even a proposed determination by the Council.

[22] There are several members of the IAIS from the United States: the individual State insurance commissioners, including the Missouri Director of Insurance, Financial Institutions, and Professional Registration, John Huff; the NAIC; and Treasury's Federal Insurance Office, whose director is Michael McRaith.

[23] FSB, Press Release: "FSB identifies an initial list of global systemically important insurers (G-SIIs)" (July 18, 2013) ("For the institutions identified today, implementation of enhanced group-wide supervision commences immediately … ."); *See also* FSB, "Global systemically important insurers (G-SIIs) and the policy measures that will apply to them" at ¶¶4, 7.

View of Director John Huff, the State Insurance Commissioner Representative

I do not believe that there is a sufficient basis for the Council's final determination that Prudential's material financial distress could pose a threat to the financial stability of the United States. In particular, there appears to be a lack of recognition given to the nature of the insurance business and the authorities and tools available to insurance regulators. Insurance is not the same as a banking product yet the Statement of the Basis for the Council's Final Determination (the "Basis") inappropriately applies bank-like concepts to insurance products and their regulation, rendering the rationale for designation flawed, insufficient, and unsupportable. Consumers purchase insurance primarily to indemnify against a contingent event, protect against property loss or damage, replace the loss of income in the event of death or disability, and provide stable retirement income. Indeed, consumers seek insurance as a source of stability even in times of economic stress and the authorities of insurance regulators have long protected insurance consumers in difficult times such as the Great Depression and the recent financial crisis. For these and the following reasons, the analysis continues to be insufficient in several key respects:

1) The Basis identifies the asset liquidation channel as a primary concern regarding Prudential's potential threat to U.S. financial stability yet it offers merely speculative outcomes related to the liquidation of assets that are not supported by a sufficient understanding of the heterogeneity of insurance products or insurer asset disposition. There is little analysis linking realistic but severe liability run scenarios to readily available liquidity, liquidity obtained through asset sales, and the impact of such asset sales on financial markets. Without such analysis, it is difficult to attach any credibility to the conclusions in the Basis.

   The Basis discusses liabilities with certain withdrawal characteristics, presuming that a large majority of Prudential's policyholders would exercise withdrawal rights as depositors to a bank might. It suggests that a significant amount of Prudential's liabilities would be subject to policyholder surrender and payout, but summarily dismisses scenarios more supportable by the evidentiary record involving much lower amounts. In doing so, the Basis does not give sufficient weight to contractual provisions that allow Prudential to manage a significant amount of the potential withdrawals over a lengthy period of time and the ability of regulators to impose additional stays on surrenders. Rather, the Basis merely speculates, without any evidence, that the imposition of stays or contractual deferrals of surrenders would undermine confidence in insurance markets to such a degree that it would threaten the financial stability of the United States.

   In fact, all of these scenarios are highly unlikely as they effectively assume that all policyholders eligible to surrender their policies will do so despite the significant

disincentives to policyholder withdrawals including federal income tax liability, federal income tax penalties, surrender penalties, and the loss of guarantees., which the Basis gives little weight. The Basis also asserts that policyholders, in deciding whether to surrender, would consider the amount of the death or retirement benefit as a less important consideration than the cash surrender value, which is much lower than the death benefit. It further argues that the more appropriate comparison would be between the cash surrender value and the "associated liabilities" (i.e., the reserve), explaining that the comparison to the death benefit does not take into account the time value of money or the payments policyholders would continue to make. This is simply incorrect. In making any decision to surrender an insurance policy, policyholders would not know the reserve amount of their policy (which requires an actuarial calculation to determine) and would instead consider the reason they purchased the policy, the death or retirement benefit. In light of this, it is beyond comprehension how policyholders would be able to or even why they would desire to make any other comparison except as between the cash surrender value and the death or retirement benefit. Most policyholders do not view their insurance policies as checking accounts, or even as typical investment accounts. Policyholders pay premiums to obtain the protection insurance provides.

The Basis also fails to demonstrate that the potential extent of the assets required to be liquidated to pay policyholder surrenders under such scenarios would be significant enough to pose a threat to the financial stability of the United States. In this context, the Basis does not give appropriate weight to evidence demonstrating that Prudential's holdings do not comprise a disproportionately large share of any asset market.

2) The exposure channel analysis is not a compelling basis for the final determination as it does not set forth sufficient evidence to conclude that Prudential's exposures to different counterparties are significant enough to pose a threat to the financial stability of the United States. The Basis also does not adequately analyze actions taken by Prudential's counterparties, which include several of the largest U.S. banks, or their regulators, which include several of my fellow Council members, to manage the risks arising from transactions with Prudential or other financial counterparties. In attempting to address the fact that individual exposures would not have a systemic impact, the Basis aggregates exposures and argues that together such exposures could pose a threat to the financial system of the United States. In so doing, the Basis merely demonstrates that Prudential is a large insurance company, yet it has been a long accepted principle of this process that size alone is not a sufficient basis for designation.

With respect to exposures to policyholders, the Council does not set forth a reasonable basis to conclude that the financial stability of the United States would be threatened if policyholders were unable to access cash surrender values or suffered losses in the event of Prudential's material financial distress. Accordingly, reliance on such scenarios is inappropriate. It also overstates the guaranty fund's importance to the analysis and does not sufficiently support the apparent conclusion that the impact of Prudential's failure on the guaranty fund system could pose a threat to the financial stability of the United States.

3) Some of the statements and arguments in the Basis suggest a lack of appreciation of the operation of the state-based regulatory framework, particularly its resolution processes. The Basis states that the authority of an insurance regulator to ring-fence the insurance legal entity could complicate resolution and could pose a threat to financial stability. Ring-fencing is a powerful regulatory tool utilized by insurance regulators to protect policyholders. In fact, ring-fencing augments financial stability by providing policyholders with the confidence that their policies will be honored, thereby reducing the likelihood and amount of policyholder surrenders as well as decreasing asset liquidation risk. Moreover, ring-fencing does not necessarily prevent a transfer of assets; rather it prevents the transfer of assets without regulatory approval. Accordingly, regulators—U.S. and international—can use this tool to ensure assets remain with the firm long enough to assess liabilities and determine the most appropriate approach to resolving the firm.

   In addition, while Prudential may be a complex organization as suggested by the Basis, it is not clear how that complexity translates into a threat to the financial stability of the United States as defined in the Council's rule and guidance, as the analysis does not properly take into account key elements of the insurance resolution process. Insurance regulators have a history of working together in judicially overseen and orderly resolutions.

4) The Basis also mischaracterizes, does not sufficiently consider, or otherwise ignores other regulatory authorities and tools. These authorities and tools include, but are not limited to, the ability to take over the company by placing it in administrative supervision or declaring it to be in hazardous financial condition, regulatory risk-based capital triggers, and the ability to stop or slow surrenders. In the event of Prudential's material financial distress or failure, insurance regulators have the authority to take action to minimize the impact that Prudential's failure would have on policyholders and counterparties. Given that one of the primary concerns is policyholder surrenders and the resulting asset liquidation, the ability of regulators to intervene to manage such surrenders is a critical component to any such analysis and should be given more recognition. Instead, the Basis speculates that the use of stays

or similar powers would undermine confidence in the insurance industry but provides no evidence to support that conclusion.

5) The Council indicated in its rule and guidance that it will consider a firm's material financial distress to be a threat to financial stability if there would be impairment of financial intermediation or of financial market functioning that would be sufficiently severe to inflict significant damage on the broader economy. While there are conclusory statements in this regard throughout the Basis, there is insufficient analysis to support application of such statements to Prudential.

6) The Council also indicated in its rule and guidance that its determination will be made on a firm-specific basis. However, the Basis includes arguments that I do not believe meet that standard, such as concerns regarding state guaranty fund capacity and implicit application of such severe macroeconomic stress that it is unclear whether Prudential is even causing or amplifying the stress in question. Further, these arguments are presented with no limiting principle, which raises concerns that broad industry or macroeconomic related issues, rather than firm-specific issues, could subject a company to designation.

In conclusion, the designation of insurance companies that could pose a threat to the financial stability of the United States is a serious exercise, the result of which could have significant implications for 1) the stability of the financial system, 2) policyholders that may be disadvantaged to the benefit of financial counterparties, 3) the cost and availability of insurance products, and 4) the competitiveness of the insurance sector. It is critically important that these decisions are based on robust analytics and a thorough understanding of the insurance business and insurance regulation. The analysis contained in the basis for the final determination in large part relies on nothing more than speculation. It gives little weight, if any, to evidence in the record, the historical experience of the insurance sector, and the expertise and experience of insurance regulators and, in particular, my colleagues in the states of New Jersey, Connecticut, and Arizona that are primarily responsible for regulating Prudential.

For these reasons, I do not believe that the Council has a sufficient basis to conclude that Prudential's material financial distress could pose a threat to the financial stability of the United States.

ROY WOODALL AND ADAM HAMM DISSENTS ON METLIFE

Views of the Council's Independent Member Having Insurance Expertise

As the Financial Stability Oversight Council's (the Council) Independent Member having insurance expertise, I dissent from the Council's Final Determination that MetLife, Inc., (MetLife) could pose a threat the financial stability of the United States if it were to suddenly and inexplicably be in material financial distress and face imminent failure. I disagree with what in the vernacular is described as the "designation" of MetLife as a "systemically important financial institution" or "SIFI."

The Resolution presented for the vote today by the Council points only to the First Determination Standard as the sole justification for the Council's determination – *that material financial distress at the nonbank financial company could pose a threat to the financial stability of the United States*. The Council's analysis using the First Determination Standard has not persuaded me, and I believe that MetLife has presented a comprehensive response to the flaws in the Council's basis for proposed determination.

I believe that there could be some findings within the Council's Notice of Final Determination and Statement of the Basis for the Financial Stability Oversight Council's Final Determination Regarding MetLife, Inc., (Notice of Final Determination) that would be useful in considering the designation of MetLife under the Second Determination Standard – *that the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the nonbank financial company could pose a threat to the financial stability of the United States*, regardless of whether the company were experiencing material financial distress.

The Second Determination Standard largely mirrors one of the ten statutory considerations the Council evaluated under the First Determination Standard.[1] However, consistent with past designations, the Council has again elected not to make a determination with respect to the company's activities under the Second Determination Standard. By not considering the Second Determination Standard, the Council has continued its practice of not informing a company of those aspects of its business that were the primary factors associated with a designation.

I do share concerns about some of MetLife's activities, particularly in the non-insurance and capital markets activities spheres, and in the resulting exposures identified and described in the Council's Notice of Final Determination in the Company Overview and Exposure Transmission Channel sections. These activities might conceivably pose a threat to the U.S. financial stability under certain circumstances. It is these types of activities that should be fully evaluated under the Second Determination Standard, as opposed to the flawed Council analysis under the First Determination Standard.

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[1] Dodd-Frank §113(a)(2), 12 U.S.C. §5323 (a)(2).

I do not, however, agree with the analysis under the Asset Liquidation Transmission Channel of the Notice of Final Determination, which is one of the principal bases for the finding under the First Determination Standard. I do not believe that the analysis' conclusions are supported by substantial evidence in the record, or by logical inferences from the record. The analysis relies on implausible, contrived scenarios as well as failures to appreciate fundamental aspects of insurance and annuity products, and, importantly, State insurance regulation and the framework of the McCarran-Ferguson Act.[2] It presumes that all current operations and activities are static without consideration of any dynamics or responses occurring before a presumed insolvency. The analysis discusses in detail, and is dismissive of, the U.S. State insurance regulatory framework, the panoply of State regulatory authorities, and the willingness of State regulators to act, thereby overstating shortcomings and uncertainties that are inherent in all regulatory frameworks, State or Federal.

In addition, I do not believe that the Critical Function or Service Transmission Channel analysis warrants acknowledgement as a fallback basis for designation, as MetLife does not appear to provide any critical financial service or product for which substitutes are unavailable.

The Council's expressed concerns in the Notice of Final Determination as to existing regulatory scrutiny, the State guaranty associations, and the potential complexities associated with the resolution of a large insurance company, seem to me to be unbalanced and lead to distorted conclusions regarding the Asset Liquidation Transmission Channel. This is also the case, in my opinion, as to those portions of the analysis that concern the existing framework for the resolution of insurance companies. If all of these system-wide concerns of the Council are legitimate, it should be using its other available tools to address them.

While the Council's approach to designation triggers supervisory jurisdiction by the Board of Governors of the Federal Reserve System (Board of Governors or Board), it does little else to promote real financial system reform. In my considered view, the Council should be more transparent about which of MetLife's activities, together or separately, pose the greatest risk to U.S. financial stability in order to provide constructive guidance for the primary financial regulatory authorities, the Board of Governors, international supervisors, other insurance market participants and, of course, MetLife itself, to address any such threats posed by the company. The Notice of Final Determination that went to MetLife, while it is hundreds of pages long, is not, in my opinion, a roadmap showing any possible exit ramp.

It is important to identify particular activities in order to encourage appropriate and further action that could lessen any company-specific threat to U.S. financial stability. Paraphrasing what one insurance thought leader once told me: "We should not tolerate any insurance company posing a threat to our financial system – pinpoint what makes them systemically risky and let's fix

[2] 15 U.S.C. §§1011-1015.

them."[3] I believe that not pinpointing specific activities that contribute to the company's systemic risk profile is a mistake. Importantly, rather than confronting the greater burden tied to the Second Determination Standard, it is easier to simply presume a massive and total insolvency first, and then speculate about the resulting effects on activities, than it is to initially analyze and consider those activities.

Speaking for myself, I believe that activities conducted by financial companies that are worth spotlighting include the extent and type of use of wholesale funding markets and other available lending facilities to fund operations, together with sizable securities lending programs, and high operating leverage, all of which could possibly pose risk to the broader markets and the U.S. financial system, particularly if such funding and credit markets access were to retract in a period of overall stress in the financial system and a weak macroeconomic environment. Potential risks to financial stability might stem not only from this vulnerability to funding market disruption, but also from the mix and scale of certain activities, which could possibly have the potential to disrupt or exacerbate market dislocations, regardless of whether a financial company is experiencing financial distress. MetLife actively participates in these funding markets and engages in securities financing transactions in a significant way.

It is possible that I might have even agreed with the Notice of Final Determination had the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of MetLife been accepted as the precursor that could affect the potential for material financial distress at the company to transmit financial instability. Indeed, in its Final Rule and Guidance, the Council recognized that there is some degree of overlap between the First and Second Determination Standards as a nonbank financial company that could pose a threat to U.S. financial stability because of the nature, scope, size, scale, concentration, interconnectedness, or mix of its activities could also pose a threat to U.S. financial stability if it were to experience material financial distress.[4] However, the Notice of Final Determination concludes that the origin of the company's systemic risk would stem from a sudden and unforeseen insolvency of unprecedented scale, of unexplained causation, and without effective regulatory responses or safeguards. I simply cannot agree with such a premise, which is the central foundation for this designation.

This decision by the Council designating MetLife should come as no surprise to anyone, as it has long been anticipated and expected. However, it may be helpful to take a quick holistic look-back to consider the chronology of certain circumstances that led to MetLife's designation.

On February 14, 2013, MetLife announced that it had deregistered as a bank holding company, as approved by the Board of Governors and the Federal Deposit Insurance Corporation (FDIC),

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[3] Therese M. Vaughan, Ph.D., Dean of the College of Business and Public Administration, Drake University, and former Iowa Insurance Commissioner, President and CEO of the National Association of Insurance Commissioners, International Association of Insurance Supervisors Executive Committee member, and Chair of the Joint Forum.
[4] 12 C.F.R., Pt. 1310 (1-1-14 Edition).

after having been supervised by the Board since 2001.[5] Many of the company's activities set forth in the Notice of Final Determination developed over this time period. Under the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), once MetLife had deregistered as a bank holding company, it then became eligible for Council review as a non-bank financial institution.[6]

On July 18, 2013, the Financial Stability Board (FSB), an international organization within the umbrella of the Group of Twenty (G-20), primarily comprising the world's finance ministers and central bankers, including the U.S. Department of the Treasury (Treasury) and the Board of Governors, announced that it had identified MetLife as a global systemically important financial institution (G-SIFI). G-SIFIs are declared by the FSB to be "institutions of such size, market importance, and global interconnectedness that their distress or failure would cause significant dislocation in the global financial system and adverse economic consequences across a range of countries."[7] Thus, MetLife was declared by the FSB as a threat not to just the U.S. financial system, but to the entire global financial system.

The FSB's announcement of the identification of MetLife and eight other insurers as G-SIFIs stated that its action had been taken "in collaboration with the standard-setters and national authorities;" and, that as G-SIFIs, these organizations would be subject to policy measures including immediate enhanced group-wide supervision, as well as to recovery and resolution planning requirements.[8] It is clear to me that the consent and agreement by some of the Council's members at the FSB to identify MetLife a G-SIFI, along with their commitment to use their best efforts to regulate said companies accordingly, sent a strong signal early-on of a predisposition as to the status of MetLife in the U.S -- ahead of the Council's own decision by all of its members.

Despite subsequent assertions by some of the Council's members that the FSB and Council processes are separate and distinct, they are in my mind very much interconnected and not dissimilar. It would seem to follow that FSB members who consent to the FSB's identification of G-SIFIs also commit to impose consolidated supervision, yet-to-be agreed-to capital standards, resolution planning, and other heightened prudential measures on those G-SIFIs that are domiciled in their jurisdictions. With respect to MetLife and the other U.S. insurance organizations declared to be threats to the global financial system - American International Group (AIG) and Prudential Financial, Inc., (Prudential) - the only way that FSB policies and measures can be imposed upon such G-SIFIs is through a determination by the Council as a

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[5] MetLife Press Release, "MetLife sheds bank holding company status with approvals from the Federal Reserve and FDIC" (February 14, 2013).
[6] See 12 U.S.C. §5311(a)(4)(B), excluding bank holding companies from the definition of "nonbank financial company."
[7] See, FSB, "Progress and Next Steps Towards Ending "Too-Big-To-Fail" (TBTF), Report of the Financial Stability Board to the G-20" (September 2, 2013), p. 8.
[8] FSB, Press Release, "FSB identified an initial list of global systemically important insurer (G-SIIs)," Ref. no: 49/2013 (July 18, 2013).

whole that material financial distress or activities occurring at such companies could: (a) pose a threat to the financial stability of the United States, and (b) should be supervised by the Board of Governors. A failure of the Council to designate MetLife would thus appear to amount to a failure of the U.S. to meet international commitments already made within the G-20.

Although it may be technically accurate to say that the FSB's declaration is not legally binding on the Council, the FSB explicitly acts in collaboration with the standard-setters and national authorities with the expectation that the intended effects will be achieved by FSB member countries. The FSB's framework for the identification of systemic risk in the financial system is clear about this intended influence: "The FSB's decisions are not legally binding on its members – instead the organisation operates by *moral suasion and peer pressure*, in order to set internationally agreed policies and minimum standards that its members commit to implementing at national level."[9]

As the FSB continues to consider other U.S. financial firms for designation as G-SIFIs, I encourage my fellow Council members whose agencies are members of the FSB to not again allow the FSB to "front-run" or pressure decisions that must be made first by the Council as a whole. Congress authorized Council members to designate U.S. and foreign nonbank financial companies at the Council level – not anywhere else. An FSB meeting with only a few Council members' agencies participating should not decide that certain firms are systemically important; or, conversely, that any firms are not systemically important, before the Council as a whole has decided those questions. To do otherwise seems to me to undermine confidence in the Council itself; to be inconsistent with the intent of Congress; and to be patently unfair to those nonbank financial companies under review that must be afforded due process and fair dealing under U.S. law and procedures.

So, now that the Council has designated MetLife a U.S. SIFI, it joins AIG, Prudential, and GE Capital Corporation (GECC), as firms under consolidated supervision by the Board of Governors. Yet, it also appears to me that perhaps all that the Council has really achieved is to resign these four companies to their pre-designation status as firms previously overseen by the Federal Government.

Prior to designation, I, like many, viewed the Federal Reserve Bank of New York as a *de facto* supervisor of AIG due to its role as lender in unusual and exigent circumstances; Prudential, as a savings and loan holding company, was subject to supervision by the Board of Governors for about one year until the company changed its thrift charter; and GECC, another savings and loan holding company, had been subject to supervision by the Board since July 2011. MetLife was supervised by the Board as a bank holding company for over a decade until it "de-banked" in early 2013, as noted earlier. Granted, now that these four U.S. nonbank financial companies

[9] http://www.financialstabilityboard.org/about/#framework (accessed December 1, 2014) (emphasis supplied).

have been designated as U.S. SIFIs, the Board of Governors' Dodd-Frank Act authorities to be applied will undoubtedly be more robust than those previously applied.

After nearly 4½ years, the Council's search for SIFIs has found potential systemic risk concentrated in the insurance sector with three of the four designated SIFIs being insurers. I am concerned as to whether different types of nonbank financial companies may be receiving disparate treatment both in the Council's analysis and processes. As the Council continues its work, it is my hope that we can concentrate our efforts to consider regulatory reform and improve regulation of those large nonbank financial companies and their activities that have been left largely unexamined since the financial crisis, but that may significantly risk financial instability. The Council's vigor in evaluating such unexamined (and in some cases unregulated) nonbank financial companies is imperative in successfully fulfilling its charge to identify threats to our financial system, economy, and the American people.

View of Adam Hamm, the State Insurance Commissioner Representative

I have serious concerns with the Basis for the Council's final determination that MetLife's material financial distress could pose a threat to the financial stability of the United States. I note that my predecessor, Director John Huff of the Missouri Insurance Department, also had concerns with the Council's Basis for the proposed designation of MetLife. Not only do I agree with his earlier assessment of the Council's Basis for the proposed designation, but I am particularly troubled that the issues he has identified have not been fully addressed in the rationale for the final designation. Specifically, the Council has failed to appropriately consider the efficacy of the state insurance regulatory system. As President of the National Association of Insurance Commissioners, I have seen first-hand how states effectively coordinate and address regulatory concerns. While the primary purpose of state insurance regulatory authorities is to protect policyholders, their attendant effect on protecting the financial system from actual or potential systemic risks should not be ignored. In addition, the Council uses a flawed asset liquidation argument that relies on speculative surrender amounts and does not appropriately take into account the insurance business model, insurance company regulation, and the disincentives policyholders have to surrender their insurance policies. Last, the Council has failed to address the criticism that it did not conduct a robust analysis of characteristics of MetLife beyond its size, particularly as it relates to the exposure channel discussion. Identifying outer boundaries of exposures and claiming they could impact a nebulously defined market is not robust analysis; it simply means the Council has identified a very large company.

I specifically take issue with the following aspects of the Council's Basis for the final determination:

1. It is disturbing that the Council continues to diminish the role of the state insurance regulatory framework, which not only reduces the likelihood of failure (an issue that the Council claims it does not have to consider), but also the impact on the financial system from the company's material financial distress. Indeed, state insurance regulators have expansive authorities and wide discretion to utilize them. This is a strength of our insurance regulatory system, and enabled state insurance regulators to effectively protect policyholders throughout the recent financial crisis. It is noteworthy that my staff sought to correct basic factual errors regarding the operation of the state regulatory system just days before the vote on the final designation of the company. Even though some errors were corrected, it is unclear whether the Council ever fully considered the nature and scope of the state insurance regulatory system. After three insurance company designations in four years, it confounds me that much of the Council and staff continue to misunderstand and mischaracterize the insurance regulatory framework.

   There is no better evidence of this than the Council's depiction of the state insurance regulatory framework in Section 5 of the Basis. In an effort to find fault with MetLife's arguments regarding regulatory scrutiny, the Council seeks to poke holes at specific tools

of state insurance regulators, particularly risk-based capital (RBC). State insurance regulators have multiple tools at their disposal to identify concerns at companies, not just RBC. RBC is an objective tool, embedded in state statutes, used by regulators on at least an annual basis to trigger specific actions when an insurer's surplus drops below regulatory thresholds based upon key risks for the insurer. Other regulatory tools, which the Basis inaccurately describes in several respects, such as ongoing examination and analysis programs, are designed to identify concerns, require information on a more frequent basis than RBC, and exist to address specific issues before RBC is triggered. Moreover, state insurance regulators can declare that a company is in Hazardous Financial Condition, which is a tool available to all state insurance regulators, and provides them the ability to take a wide range of actions beyond those specifically identified in the Basis: including reducing, limiting, or suspending the volume of business; limiting or withdrawing from certain investments and investment practices; suspending or limiting dividends; correcting corporate governance deficiencies; and imposing stays, among others. The Basis fails to fully consider the range of mechanisms insurance regulators use to identify and address problems despite their being equally or even more important than RBC. Not only do these tools help prevent solvency concerns with the company, but, as a result of our authorities allowing for early regulatory intervention and ongoing supervision, they also minimize the impact of any material financial distress on policyholders, other counterparties and the system. Disregarding the full scope of state insurance regulatory authorities misapplies Section 113 of the Dodd-Frank Act that the Council appropriately take into account the degree to which the company is already regulated when making a determination that a company could pose a threat to the financial stability of the United States.

2. Notwithstanding the valid argument that MetLife raises about the likelihood of the company's failure, even if you assume material financial distress at MetLife and that the Council had a fulsome understanding of the system (which for the reasons above I do not believe it does), the Council's description of existing regulatory scrutiny misses the mark. To effectively assess how regulation mitigates the risks the firm poses to financial stability, the Council should have sought to match the areas of concern to the authorities of existing regulators to address those concerns. The Basis fails to do this. As a result, the Basis fails to acknowledge that most, if not all, of the concerns it identifies (several of which have questionable merit) are addressed by the existing regulatory structure. This omission makes the Council's rationale for its decision fundamentally flawed.

   This is particularly the case with the asset liquidation channel discussion. For example, the Council raises concerns with significant policyholder surrenders in the event of MetLife's material financial distress and any attendant asset liquidation resulting from those surrenders. Insurance regulators have the authority to impose stays or apply similar

powers to manage heightened policyholder surrender activity. Consistent with the objectives of insurance regulation, these actions can be taken to preserve assets for policyholders, who do not or cannot surrender their policies, in order to ensure their insurance claims can be paid in the future. Fears of surrenders leading to mass asset liquidation are thus unfounded, as insurance regulators have the ability and, moreover, the responsibility to take action in such an event. To the extent that the Council speculates about such stays leading to further contagion across the insurance industry, insurance regulators have extensive authorities to intervene to protect policyholders at these other firms as well. It is worth noting that our authorities are flexible and provide us substantial means to quell panic. Even when a stay is implemented, insurance regulators can allow the release of funds in certain circumstances such as, for example, when a policyholder faces a financial hardship or similar emergency. With respect to the exposure channel, it is also worth noting that several of the exposures of concern to the Council appear to be primarily with entities that are regulated by Council member agencies. If Council members are concerned about their regulated entities' exposures to MetLife, it is far more effective to limit those entities' exposures to MetLife than to designate MetLife. In fact, the state insurance regulatory system has investment laws that include limitations on the maximum exposure to any single issuer to ensure our regulated entities are not unduly exposed to any one entity, irrespective of its size or perceived risks that entity may pose to the financial system.

It is unclear from the Basis what additional tools beyond those already at an insurance regulator's disposal could effectively address the risks the Council identifies, which are, in large part, concerns emanating from insurance legal entities that state insurance regulatory authorities are specifically designed to address. As Benjamin Lawsky, Superintendent of the New York Department of Financial Services, noted in his letter of July 30, 2014, his department and other state regulators employ a wide array of tools in supervising MetLife including, but not limited to: constant and ongoing supervision and examination, limitations on the type of and concentration of invested assets, risk-based capital and reserving requirements focused on early intervention in times of distress; review of filed derivative use plans; prior approval of intercompany transactions; prior approval of new policy types, rates and lines of business; financial reporting; and statutory accounting requirements that are more conservative than Generally Accepted Accounting Principles. Suggestions or assertions that a consolidated regulator would more effectively address the identified potential risks should be supported by a description of the tools, how they explicitly address the systemic risks identified, and experience from past financial crises, lest they appear without merit or self-serving. For example, while requiring additional capital is a useful tool, a capital surcharge cannot prevent let alone substantially mitigate the impact of a hypothetical insurance policyholder run of all applicable policies that the Council identifies in the Basis. Simply

put, the tools at the disposal of state insurance regulators are either equally or more effective than the enhanced prudential standards that would be at the Federal Reserve's disposal in addressing many of the risks the Council identifies.

3. Despite verbiage sprinkled throughout the Basis indicating the Council considered a range of scenarios detailing the potential impacts of the material financial distress of MetLife, it remains unclear to me what specific scenarios were presented to the Council and therefore it is impossible to evaluate whether those scenarios were appropriate to apply to an insurance company. To the extent the Council believes the Basis sets forth appropriate scenarios, I must respectfully disagree. For example, in analyzing asset liquidation, nowhere in the Basis does the Council a) delineate stressed run scenarios, including the impact of company and/or regulatory stay activities, b) identify asset liquidation scenarios and their impacts to specific and defined financial markets; and c) compare those impacts to normal and stressed ranges of variance in those specific and defined markets. Moreover, the Basis implicitly assumes material financial distress at all insurance entities at the same time, yet the Basis cites no historical examples of that having ever occurred. Each legal entity insurer has unique characteristics and writes different products, which have different policyholder characteristics. Accordingly, each insurance entity would react to stress differently and its regulator would appropriately respond differently to those specific circumstances.

   As for the exposure channel, the Council makes claims that retail policyholders or corporate customers would suffer losses as a result of material financial distress at MetLife, but does not detail how those losses translate into "an impairment of financial intermediation or of financial market functioning that would be sufficiently severe to inflict significant damage on the broader economy." Unsubstantiated qualitative statements describing "concerns," or "potential negative effects," for example, should not be a substitute for robust quantitative analytics that demonstrate scenarios that MetLife's material financial distress could have substantial impacts to particular asset markets or the financial system as a whole. Saying it does not make it so.

4. A key consideration for the final designation is the asset liquidation channel. The final Basis, like the proposed Basis, continues to offer merely speculative outcomes related to the liquidation of assets based in large part on hypothetical and highly implausible claims of significant policyholder surrenders. To remedy this, the Council offers additional analysis in an appendix, but that analysis treats all financial institutions exactly the same using broad-based assumptions regarding asset dispositions that do not take into account the specific characteristics of MetLife, its assets and liabilities, the particular characteristics of insurance products or insurance policyholder behavior. There is no explicit provision for the differences in timing and the assets of MetLife are categorized

using bank asset categories even though they are substantially different. In contrast, an economic consulting firm, on behalf of MetLife, prepared an analysis that more appropriately captured the unique characteristics of the insurance business model and was tailored to MetLife's products and asset profile. Notwithstanding that this analysis also did not take into account regulatory intervention, the analysis studied multiple scenarios (some of which are highly implausible in my estimation) that linked liability runs to MetLife's available liquidity, liquidity obtained through asset sales, and the impacts of those sales on financial markets. It concluded that any asset liquidation that might take place as a result of MetLife's material financial distress would not pose a threat to the financial stability of the United States. The Council offered some critiques regarding the sensitivity of assumptions and results of this analysis, but still failed to perform a suitable analysis of its own.

Even assuming the Council's asset liquidation analysis was appropriate otherwise, it does not take into account the impact of regulatory intervention as described above. This is exacerbated by the Council's failure to appreciate the historical effectiveness of the insurance regulatory system in crisis. For example, in response to the arguments by MetLife seeking to analogize the impacts of a failure of MetLife to other insurance company failures in history, the Council notes correctly that the failure of an insurance company of MetLife's size and scope has never taken place. While that is a fair statement as each company has its own unique characteristics, the fact that there is no comparable insurance failure is a testament to the state insurance regulatory system, a fact that the Council ignores. The Council effectively assumes lack of regulatory intervention in the discussion or otherwise fails to take into account the breadth and effectiveness of the authorities at a state insurance regulator's disposal. As a result, the Council's analysis misapplies Section 113, which requires the Council to consider existing regulatory scrutiny in determining whether a company's material financial distress could pose a threat to the financial system of the United States.

5. With respect to the exposure channel analysis, the Council appears to be primarily concerned that that the company is large. The discussion of the exposure channel fails to set forth sufficient evidence to conclude that MetLife's exposures to various counterparties are large enough individually or in the aggregate to pose a threat to the financial stability of the United States. While the Council acknowledges mitigants such as those identified by MetLife in its comprehensive submission in opposition to its proposed designation, the Council fails to incorporate them in a meaningful way in its exposure discussion. As a result, any large company could meet the standard applied by the Council in the exposure channel even if individual exposures were relatively small and well within regulatory limits. Importantly, the Council fails to consider the mitigating benefits to a company of spreading its risks across different counterparties,

leaving large companies unable to determine the Council's specific concerns with their investment behavior given the illogic that both spreading and concentrating investments can be the basis for designation.

6. I also take issue with certain arguments that are not firm-specific. For example, the Council raises concerns that a MetLife failure could stress the guaranty fund system. To the extent the Council takes issue with the capacity of the guaranty funds more broadly to handle other insurer failures, that is an issue with the guaranty fund system not MetLife. Another example is the Basis' treatment of MetLife's Funding Agreement Backed Securities Programs and their impact on money market funds in the event MetLife would be unable to meet its obligations under those contracts. The Securities and Exchange Commission (SEC) has issued rules to address the concerns relating to the risk of money market funds "breaking the buck." Broad-based reform such as the SEC rules rather than designation is the more appropriate vehicle for addressing concerns about money market funds. While I support the SEC's efforts, if the Council does not believe that the new rules adequately addresses its concerns with money market funds, it should work with the SEC to resolve such concerns rather than designating firms such as MetLife that have exposures to money market funds.

7. At its core, the Basis demonstrates that the Council has created an impossible burden of proof for companies to meet as it effectively requires companies to prove that there are no circumstances under which the material financial distress of the company could pose a threat to the financial stability of the United States. It remains to be seen whether this approach is legally tenable. Even if one assumes, however, that it is legally tenable and it is not necessary to ascribe the likelihood of any one scenario, that should not excuse the Council from setting forth specific quantitative scenarios, based on reasonable, albeit stressed assumptions, demonstrating that the material financial distress of the company meets the statutory standard. Without applying some sort of overlay of plausibility, any large company could meet the statutory standard as applied by the Council. Yet it is well established that size cannot be the only criterion for designation. If it were, Congress would have passed a law treating nonbanks the same as bank holding companies, requiring Federal Reserve supervision and enhanced prudential standards to any company above a certain size threshold. Because Congress did not do this and specifically required that the Council consider at least 10 statutory considerations (not the least of which is the "the degree to which the company is already regulated"), the Council should do more than put together a lengthy discussion that raises concerns with the characteristics of any large company.

Finally, I would be remiss if I did not mention that, despite the sheer volume of arguments (no matter how far-fetched) contained in the Basis, the Council fails to identify the specific set of legitimate issues of concern that has led to the company's designation. Our goal as a Council

should be to reduce systemic risks to the U.S. financial system. While designation of a company is just one tool to address systemic risks, if it is going to be a useful one, the Basis for this designation should clearly delineate the causes of the Council's concern, be based on robust analytics designed to demonstrate the evidentiary basis for such concerns, and provide the company a clear roadmap as to the rationale for its designation. Absent a clear rationale from the Council and an "exit ramp" from designation, neither the company nor its regulators can realistically determine how best to proceed in reducing the company's risk to the system and eliminating its "Too Big to Fail" status.

For the reasons set forth above, I have serious concerns with the Basis for the final designation of MetLife.

STATEMENT OF THE NATIONAL ASSOCIATION OF MUTUAL INSURANCE COMPANIES

NAMIC®
NATIONAL ASSOCIATION OF MUTUAL INSURANCE COMPANIES

Statement

of the

National Association of Mutual Insurance Companies

to the

Senate Committee on

Banking, Housing, and Urban Affairs

hearing on

"FSOC Accountability: Nonbank Designations"

March 25, 2015

The National Association of Mutual Insurance Companies (NAMIC) is pleased to provide comments to the Senate Committee on Banking, Housing and Urban Affairs on the Financial Stability Oversight Council's designation of nonbank firms as Systemically Important Financial Institutions.

NAMIC is the largest property/casualty trade association in the U.S.A., serving regional and local mutual insurance companies on main streets across America as well as many of the country's largest national insurers. NAMIC consists of more than 1,300 property/casualty insurance companies serving more than 135 million auto, home, and business policyholders, with more than $208 billion in premiums accounting for 48 percent of the automobile/homeowners market and 33 percent of the business insurance market.

Introduction

To begin, it is important to understand that the nature of property/casualty insurance products, the industry's low leverage ratios, its relatively liquid assets, and the lack of concentrations in the marketplace make our industry truly unique within the financial services sector. This uniqueness also makes our business fundamentally different from the other two major components of the insurance business – life insurance and health insurance. The property/casualty insurance industry was not responsible for the recent economic crisis and in fact, the risk that our companies pose to the overall financial system is negligible.

Recent historical evidence supports this claim. Even amid severe financial turmoil, there were no major failures of property/casualty insurers and the industry as a whole greatly outperformed other financial services sectors. Today the industry remains strong, diverse, and vibrant – there are more than 2,700 property/casualty insurers operating in the United States, the majority of which are relatively small. A number of studies over the years, including those conducted by the U.S. Department of Justice, state insurance departments, and respected economists and academics, have consistently concluded that the insurance industry is very competitive under classic economic tests.

In short, the record shows that property/casualty insurers did not cause the last crisis and it is exceedingly unlikely that property/casualty insurers - either individually or collectively - could cause a financial crisis in the future.

Financial Stability Oversight Council and Systemic Risk

Section 111 of the Dodd-Frank Wall Street Reform and Consumer Protection Act established FSOC and subsequent sections tasked it with identifying risks to the financial stability of the United States that could arise from the material financial distress of large, interconnected bank holding companies or nonbank financial companies. This authority includes making recommendations concerning the establishment of

heightened prudential standards for risk-based capital, leverage, liquidity, contingent capital, resolution plans and credit exposure reports, concentration limits, enhanced public disclosures, and overall risk management of such institutions.

FSOC also has authority to require supervision by the Federal Reserve Board of Governors for nonbank financial companies that may pose a threat to the financial stability of the United States in the event of their material financial distress or failure. Section 113 establishes a number of criteria for FSOC to consider in making a determination as to whether a particular company should be subject to such supervision. The Council must consider:

- The extent of the leverage of the company;
- The extent and nature of the off-balance-sheet exposures of the company;
- The extent and nature of the transactions and relationships of the company with other significant nonbank financial companies and significant bank holding companies;
- The importance of the company as a source of credit for households, businesses, and State and local governments and as a source of liquidity for the United States financial system;
- The importance of the company as a source of credit for low-income, minority, or underserved communities, and the impact that the failure of such company would have on the availability of credit in such communities;
- The extent to which assets are managed rather than owned by the company, and the extent to which ownership of assets under management is diffuse;
- The nature, scope, size, scale, concentration, interconnectedness, and mix of the activities of the company;
- The degree to which the company is already regulated by 1 or more primary
- financial regulatory agencies;
- The amount and nature of the financial assets of the company; and
- The amount and types of the liabilities of the company, including the degree of reliance on short-term funding.

In making a determination to designate any nonbank financial company as systemically significant and subject to federal consolidated supervision and higher prudential standards, FSOC must consult with the primary financial regulator. In addition, the Council must review and reevaluate any designation on an annual basis.

As it has not been strictly defined, the category of nonbank financial companies ostensibly includes property/casualty insurers. However, the legislative history of Dodd-Frank makes clear that lawmakers generally did not believe that insurers pose a systemic risk. Additionally, many economists agree that the risk the property/casualty industry poses to the overall financial system is negligible. As mentioned above, the industry is highly competitive, well capitalized, and subject to adequate financial and operational regulation. In addition, property/casualty insurers are not as susceptible to the adverse systemic consequences of activities engaged in by banks and other financial institutions that are the principal generators of systemic risk.

In order to understand the relationship between systemic risk and the insurance industry, it is important to understand what is meant by "systemic risk." Systemic risk is often defined as the probability that the failure of one financial market participant to meet its contractual obligations will cause other participants to default on their obligations, leading to a chain of defaults that spreads throughout the entire financial system, and eventually to the nonfinancial economy generally. Another type of systemic risk results from the possibility that a major external event could produce nearly simultaneous, large, adverse effects on most or all of the financial system (rather than just one or a few institutions) such that the entire economy is adversely affected. In this scenario, the threat to the system is a market-oriented crisis rather than an institution-oriented crisis. That is, the crisis occurs because of a widespread event or trend that occurs throughout the financial system, rather than because of the behavior of a particular institution or industry. Market-oriented crises tend to begin with a large change—usually a decline—in the price of a particular asset; the change then becomes self-sustaining over time.

The global financial crisis that began in 2008 was a market-oriented crisis. The financial system broke down not because of a contagion that radiated from one or a few troubled institutions to a host of otherwise healthy entities. What happened instead is that market participants around the world independently speculated that a particular asset class—housing, in this case—would continue indefinitely to increase in value.

Future crises are likely to arise from similar types of asset bubbles and instances of widespread failure by market participants in evaluating certain types of risk. Therefore, regulation that is intended to curtail systemic risk must be carefully designed to address the kind of market-oriented problems that caused the recent crisis and might potentially lead to future crises. The record shows that property/casualty insurers did not cause the last crisis and it is exceedingly unlikely that property/casualty insurers - either individually or collectively - could cause a financial crisis in the future.

There are six primary factors that affect the probability that a financial institution will create or facilitate systemic risk: leverage, liquidity, correlation, concentration, sensitivities, and connectedness. A holistic examination of these factors will demonstrate that there is no basis for regulating property/casualty insurance companies for systemic risk because they do not present such a risk.

Additionally, unlike lightly regulated financial institutions such as investment banks and hedge funds, most of the obligations of property/casualty insurers are protected by the state-based insurance guaranty fund system. This nationwide system, which is financed by the property/casualty insurers of each state, greatly mitigates the effect of any failing property/casualty insurer by providing claimants assurance that the insurer's obligations will be satisfied on a timely basis.

As it is clear that property/casualty insurers pose no systemic risk to the nation's economy or financial structure, efforts to designate them under Section 113 simply by

virtue of their classification as financial service providers ignore the underlying business models and financial structure of the industry. There are many other industries more concentrated and interconnected - such as energy, telecommunications, and transportation - that could pose a more serious threat to the nation's economy in the event of failure, than the diverse and financially stable property/casualty insurance industry.

It is imperative that FSOC consider the property/casualty industry in the context of the larger national and global financial services industry and particular companies in the context of the industry as a whole. The Council must resist the temptation to base decisions on size alone or feel compelled to designate an insurer – or group of insurers – simply for the sake of including a representative of all financial industry sectors. Failure of regulators to make the critical distinctions between property/casualty and other financial market participants could result in substantial anti-competitive consequences and increased prices for important consumer financial products, which ultimately hurts consumers without providing any commensurate benefit in protecting U.S. financial stability.

Concerns for the Future

Though the property/casualty insurance industry has not to date been a focus for the FSOC, NAMIC remains concerned that this may eventually change. Of particular concern is the conspicuous habit of the FSOC to go against the advice of the insurance experts that it has on the panel when it comes to designating insurers as SIFIs. Former FSOC member and Missouri insurance commissioner John Huff has said, "Banking regulators should not be making designation decisions that could have impacts on firms and markets in which they have no experience or authority overseeing, like insurance."[1]

As one key example, Roy Woodall, the one insurance representative with a vote on the FSOC, voted against the designation of Prudential as a SIFI. At the time, Commissioner Huff also expressed concerns with the designation saying that "at its core, the basis for Prudential's designation is grounded in implausible, even absurd scenarios," and that "appropriate respect for those who have been involved in regulating the sector and understand it best would be a good start."[2]

Commissioner Huff has also publicly stated that it is clear that "some of my fellow FSOC members may not understand the insurance industry" or understand how insurance works. Specifically, these comments were made at a recent NAIC meeting where he referred to the arguments the FSOC used in its analysis of AIG--such as a possible run on the company and the loss of confidence in the insurance sector should one insurer fail--as a "very bank-centric approach."

Part of the more fundamental challenge for the insurance industry – and nonbank financial firms more broadly – is the lack of transparency surrounding both the

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[1] http://www.propertycasualty360.com/2013/12/16/fsoc-insurance-members-criticize-councils-approach
[2] Ibid.

designation criteria as well as the process by which a company might remove a SIFI designation. Again, Roy Woodall may have said it best when he said of the FSOC approach to designation insurance companies that it, "provides no direction, clarity or transparency to the public or to state insurance regulators, international supervisors, the companies themselves—or even FSOC members as to what activities need to be addressed or modified." NAMIC urges Congress to continue pushing the FSOC to bring more direction, clarity, and transparency to the process to ensure that insurance companies are no inappropriately designated as SIFIs.

STATEMENT SUBMITTED BY STEPHEN D. STEINOUR, CHAIRMAN, PRESIDENT, AND CEO, HUNTINGTON BANCSHARES, INC.

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March 25, 2015

The Honorable Richard Shelby
Chairman
Senate Committee on Banking, Housing & Urban Affairs
534 Dirksen Senate Office Building
Washington, D.C. 20510

The Honorable Sherrod Brown
Ranking Member
Senate Committee on Banking, Housing & Urban Affairs
534 Dirksen Senate Office Building
Washington, D.C. 20510

Re: Examining the Regulatory Regime for Regional Banks

Dear Chairman Shelby and Ranking Member Brown:

Thank you for your leadership and interest in examining the important role regional banks play in supporting the growth and success of our economy.

Huntington appreciates the opportunity to share our perspective on the regulatory regime for regional banks, a public policy question that directly impacts our ability to best service our customers. For Huntington, as for the other regional banks, a sound financial regulatory system is of benefit to us and the public. While we appreciate that the Dodd-Frank legislation enacted five years ago provided meaningful improvements to that system in many respects, we also believe establishing the $50 billion asset threshold designating Huntington and other regional banks as Systemically Important Financial Institutions (SIFI) bears reexamination. The current threshold is out of balance with any real risk our business model poses to the economy, and it results in significant lost opportunity to invest more deeply in our communities and their respective neighborhoods and small businesses.

Huntington Bancshares Incorporated has been serving our local communities since 1866, under our founder's name, conducting our business in alignment with the Midwest values we have shared with our customers for nearly 150 years.

Today, we sit headquartered on the same corner of Broad Street and High Street in Columbus, Ohio, where our bank has been a foundational partner supporting the generations of families and businesses that have made our city an economic leader in the Midwest. This cornerstone role we play in the economic, civic, and philanthropic fabric of our markets is a story echoed in all of the neighborhoods we support in Ohio, Michigan, Pennsylvania, Indiana, West Virginia and Kentucky, where we have consistently worked to do the right thing for our customers and communities through 700 traditional branches, 1,500 ATMs, and through the employment of more than 12,000 colleagues, an approach that has allowed us to steadily and prudently grow throughout our history to $66 billion in assets today.

While Huntington has gotten larger over time, our overall approach to risk and stability remains the same as that advanced by our founder, P.W. Huntington, "*In Prosperity be Prudent, In Adversity Be Patient.*" Indeed, it has been that approach that, regardless of our size, has served our customers, our communities, our shareowners, and the overall financial system well over periods of both prosperity and adversity, including some of the most challenging in our nation's history.

Our approach of investing our business success back into the communities that trust in us is one of the hallmarks of regional banking. By providing consumer, small business and commercial services, we leverage our balance sheet primarily to support enhanced loans and investments toward making consumer financial dreams a reality and to partnering with businesses to create jobs and economic growth for the region. This focus is evidenced by our leadership today as the #1 SBA lender in the nation, intentionally driving the economic resurgence of the Midwest, despite ranking as only the 36th largest bank in the United States.

The safety and soundness of our institution are our first priority. As you know, financial regulators have dedicated office space in our headquarters and continually examine the bank and our operations to ensure that we are in alignment with soundness and security standards. It is vigorous and ongoing. When Dodd-Frank became effective in July of 2010, Huntington was $51.7 billion in assets, just over the line that would designate us as a SIFI without consideration of our business model, complexity or true risk profile.

This designation subjected Huntington to substantial new enhanced regulatory requirements, which now dominate the strategic planning and governance practices of the bank. Moreover, as a result of the designation, we have invested and redirected significant resources to build new departments, systems and procedures to validate and demonstrate compliance with the substantial requirements.

The resulting annual aggregate expense to comply with these new Dodd-Frank standards exceeds $40 million and is growing. The application of many of the provisions appear misplaced for a regional bank such as Huntington, and represent not only a significant expense increase, but also a loss of opportunity to further advance our strong track record of local lending, partnerships and economic development investments.

Some argue against making any changes to the current threshold, purporting that this is a small price to pay for a sound financial environment, or that these requirements can be tailored or modified, or that banks can seek exemption from requirements, some of which have still not been completely implemented.

This misses the larger picture. Public policy in this area should and must be about managing risk. It is the standard against which we think financial institutions, small to large, should be evaluated.

Banking is about risk, and managing and planning around those risks. Capturing institutions based on size alone is not indicative of systemic risk. Indeed, now there is enough data to be confident that size – particularly at the regional bank level – is among the least effective measurements of risk.

As stated earlier, Huntington is the 36th largest bank. A recent Office of Financial Research (OFR) study evaluated the largest 33 banks, including a host of peer regional banks. While this study did not formally include Huntington, the report's findings on the vast difference between risk at the largest banks and risks at regional banks are instructive. We have included data on these factors, which is consistent between Huntington and our peer regionals. The enclosed chart compares these risk measurements, in comparison to the largest global systemically important banks (G-SIBS) and our peers in the regional bank market.

Huntington: A Traditional Business Model

	Regional Banks	G-SIBs	Huntington
Core Deposits / Total Assets	72%	29%	76%
Net Loans to Total Deposits Ratio	88%	61%	92%
Net Loans to Total Assets Ratio	65%	21%	72%
Foreign Deposits / Total Deposits	<1%	28%	<1%
Foreign Loans / Total Loans	<1%	18%	2%
Trading Assets / Total Assets	1%	16%	<1%
Broker-Dealer Assets / Total Assets	2%	19%	<1%
Derivatives Contracts as percentage of Total Assets	46%	2549%	43%

To support an optimally functioning financial system that remains the unquestioned global leader, we must look to a more comprehensive approach to judging risk.

While we are very proud of our industry leading community commitments, we believe our investments could be stronger and more impactful if our regulatory burden was dictated by our actual systemic risk rather than being determined by an arbitrary number that does not measure the many factors that play into a business model's actual risk.

We encourage the Committee to consider many of the models that have been discussed that measure behavior and risk, and tie a systemic risk designation to a broader set of financial and operational components. We believe a more thoughtful review of factors such as size, complexity, interconnectedness, global or geographic exposure, and/or non-bank assets concentration can render an approach that more accurately protects the public and their confidence in the financial system.

Thank you again for your service, leadership and commitment to engaging in a thoughtful debate on this critically important issue.

Sincerely,

Steve Steinour

Stephen D. Steinour
Chairman, President and CEO